AFTER BLACKSTONE: SHOULD SMALL INVESTORS BE EXPOSED TO RISKS OF HEDGE FUNDS?

HEARING

BEFORE THE

SUBCOMMITTEE ON DOMESTIC POLICY

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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CONTENTS

AFTER BLACKSTONE: SHOULD SMALL INVESTORS BE EXPOSED TO RISKS OF HEDGE FUNDS?

WEDNESDAY, JULY 11, 2007

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC POLICY,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 1 p.m., in room 2154, Rayburn House Office Building, Hon. Dennis J. Kucinich (chairman of the subcommittee) presiding.

Present: Representatives Cummings, Kucinich, Davis of Illinois, Tierney, Watson, Braley, Cannon, Issa, and Bilbray.

Also present: Representative Hodes.

Staff present: Jaron Bourke, staff director; Charles Honig, counsel; Jean Gosa, clerk; Evan Schlom, intern; Natalie Laber, press secretary, Office of Congressman Dennis J. Kucinich; Leneal Scott, information systems manager; and David Marin, minority staff director.

Mr. KUCINICH. Good afternoon. The Subcommittee on Domestic Policy of the Committee of Oversight and Government Reform will now come to order.

Today's hearing will take a closer look at loosened initial public offerings of hedge funds and private equity funds and the risks they pose to small investors.

Without objection, the Chair and ranking minority member will have 5 minutes to make opening statements, followed by opening statements not to exceed 2 minutes by any other Member who seeks recognition.

Without objection, Members and witnesses may have 5 legislative days to submit a written statement or extraneous materials for the record.

Without objection, we will be joined on the dias by Members not on our committee for the purposes of participating in this hearing and asking questions of our witnesses.

Good afternoon. This hearing's purpose is to shed light on a serious challenge to America's decades-long commitment to protecting small investors, brought to public attention by the recent public offering of Blackstone LP. Hedge funds and private equity funds are risky, and they operate under exemptions from traditional investor protections.

Under current law, hedge funds and private equity funds may not be sold to small investors. They deploy investment strategies

that are otherwise prohibited, and they possess the potential for rich rewards. But at the same time, they are characterized by real potential risks of callosal failure, illustrated by the collapse of two Bear Sterns hedge funds just 2 weeks ago, and the collapse of Amaranth Partners and Long Term Capital some years ago.

The public offering of Blackstone LP 2 weeks ago and the offering of the Fortress Investment Group that preceded it marked the attempt to mainstream a new financial arrangement that effectively presents small investors with the ability to invest in the management of hedge funds and private equity funds. I am concerned that the effect is to expose small investors to risks that heretofore have been permitted only for large institutional investors and wealthy individuals.

Blackstone is the latest and by far the largest family of hedge funds and private equity funds that have devised a way to be traded publicly without compliance with the Investment Company Act of 1940, but it by no means will be the last. The Kohlberg, Kravis, Roberts private equity group and the Och-Ziff Capital hedge funds have already filed with the SEC to make their management companies public following Fortress and Blackstone models, and news reports indicated that other funds, such as the Carlyle Group and Apollo may not be far behind.

The subject of this hearing is this: has the SEC adequately used its existing authority to protect small investors with regard to the initial public offering of these arrangements? Is the existing law adequate to the task of protecting investors in the face of the desire and resourcefulness of hedge fund and private equity fund managers to go public? What are the new risks to small investors posed by these new financial arrangements?

I want to be clear that this hearing is not about the abolition or even the further regulation of private equity and hedge funds, nor is this hearing biased toward forbidding future offerings like Blackstone LP. The bias, if there is one, is toward the protection of small investors and how best regulation may accomplish that goal; in other words, what steps all actors in the broader regulatory system, including Congress, can and should take to militate against the risk of these novel investment vehicles.

The backbone of our financial system, one that makes it the envy of the world and an efficient machine to balance risk and reward, is our strong system of regulating public offerings. The Securities and Exchange Commission has attempted to institute some regulation of hedge funds for even sophisticated and wealthy investors. All of the witnesses that you will hear from today think that when small investors are allowed access to hedge funds and private equity funds there needs to be regulation. The question is: what type of regulation is both necessary and reasonable to strengthen our financial system?

Blackstone LP provides the point of departure. This subcommittee wrote the SEC on June 21st out of concern that insufficient time an opportunity had been allotted to examine those new risks and the soundness of the new financial arrangements. Chairman Waxman and I felt that the stakes were high, since a careful reading of Blackstone's registration statements by our staff revealed that public investors in the IPO would be assuming risks without

the traditional investor protections of corporate governance that allow investor control and without transparency and the disclosure of what is being invested in. Those risks include excessive compensation arrangements, management of self-dealing transactions with affiliates, use of substantial leverage, no diversification requirements, difficult-to-value investments, illiquid investments, no independent board members, no substantive voting rights, few fiduciary duties on management.

Eagerness by Blackstone to launch this IPO and to stymie Congress' examination of these questions is unfortunate. It should be noted that Blackstone moved up its offering date by a week, precisely when we and several other Members of Congress asked the SEC to scrutinize further the offerings. They could have allowed the inquiry to take place, and I believe it was unfortunate they didn't. But if Blackstone was able to market a black box to ordinary investors by gaming their offering date, others that follow will not.

The alternative to oversight is not pretty: it is to wait for something bad to happen; for the failure of one or several of these management complaints; and for, as in the Enron debacle, ordinary investors to lose everything, including their retirement income, and to allow the legal and economic fallout to be resolved through protracted and expensive litigation. You know, this just isn't acceptable.

So our hearing today is timely and, we hope, helpful to the cause of protecting ordinary investors. These are individuals and families who are saving for college or retirement through IRAs and 527s, mutual funds, and online trading houses. They depend upon the SEC and Congress to afford them the opportunities of our market system with protections from excessive risks and dangers which can otherwise ruin and defeat the American dream.

We will examine today, with the help of some of the Nation's leading experts, if we are living up to that challenge and if we are responsibly or irresponsibly exposing small investors to excessive risk and danger.

Thank you very much.

[The prepared statement of Hon. Dennis J. Kucinich follows:]

Opening statement
Dennis J. Kucinich, Chairman
Domestic Policy Subcommittee
July 11, 2007

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Hedge funds and private equity funds are risky and they operate under exemptions from traditional investor protections. Under current law, hedge funds and private equity funds may not be sold to small investors. They deploy investment strategies that are otherwise prohibited, and they possess the potential for rich rewards. But at the same time they are characterized by real potential risks of colossal failure, illustrated by the collapse of two Bear Stearns hedge funds just two weeks ago, and the collapse of Amaranth Partners and Long Term Capital some years ago.

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Mr. KUCINICH. With that I recognize the Honorable ranking minority member, Mr. Issa of California.

Mr. ISSA. Thank you, Mr. Chairman. I think you did a great job of characterizing the majority opinion on today's hearing, and Ido want to thank you very sincerely for holding this. I believe that there is a need for this Congress to view changes in the market, and view them with the kind of doubt that, by definition, helps protect investors large and small.

I do believe that we are holding two hearings here today. We are holding on that seems to be all about Blackstone. This IPO was not a private equity, in fact, public offering, but rather the management of a private equity. But we are also here today, without a doubt, dealing with questions of hedge funds and private equity that are being dealt with in Congress as we speak and that are being, in some cases, vilified.

So little is known about private equity industry it is easy to mischaracterize the role they play in our economy. My comments today are directed primarily at private equity funds. I am concerned that we in Congress are lumping equity and hedge funds together and looking at them as interchangeable. They are different entities and should be seen differently.

Frequently we have heard individuals such as Steve Schwartzman of Blackstone or Lew Gerstner of the Carlyle Group characterized as Masters of the Universe, invoking images of robber barons or captains of industry, to explain the business model. What is more, in every article concerning Blackstone's IPO, there were also descriptions of CEO's lavish lifestyle. These notions have led Members of Congress to advocate for increasing taxes associated with the private equity model.

Included today I put some charts up—and I have more—that specifically make it clear that one of the major recipients of both hedge funds and private equity are, in fact, both public and private entities such as union pension funds, public pension funds, and, in fact, corporate pension funds typically having between 1 and 15 percent of their portfolio in these types of investments. These investments have done well for future retirees throughout the country, running as much as 22, 23 percent return on investment year over year over year.

So it is very clear that the most sophisticated buyers, the most sophisticated buyers, these large, multi-billion-dollar pension funds with all of their professional management, have made a decision that favors a certain percentage of these investments.

It is also clear that if, not as this chairman, but as chairmen of some other committees, have been advocating, if, in fact, we choose to add a level of taxation to this process at any point, we are not going to take it out of the people and the companies that produce these profits; we are going to take it out of the pass-along to these entities. That is one of my concerns here today.

Perhaps as a proud Republican, perhaps simply as a taxpayer, I find little doubt in my mind that we are taxed sufficiently. I am not here today to advocate for a tax increase. In fact, my opinion is that we, as Americans, are fully taxed and need not look for additional tax revenue by adding to a group to vilify in order to raise their taxes.

Also, too often securities legislation has been the product of congressional hothouses. This follows closely on financial scandals or disasters. It is no coincidence that Congress passed the Security Exchange Act of 1933 or created the Securities and Exchange Commission in 1934 following the dark days of the 1929 crash and the Depression that followed.

In recent history, Congress passed during my tenure Sarbanes-Oxley Act on the heels of Enron and WorldCom disasters. Oddly enough, Sarbanes-Oxley did little to prevent that from happening again, but has added billions of dollars of legal and accounting costs to public companies, thus reducing what they can pay in dividends to the small investor that we are here today to talk of.

It is very clear that we are not here today to pass legislation in a hurry. It is clear that we should not. There has not been a disaster. There has not been some sort of an episode, including this public offering, that should cause us to hastily go to legislation. Just the opposite. I believe hearing from the Securities and Exchange Commission and from career investors and other people knowledgeable in this industry today, we will have a better opportunity to see what is right, what is more right in this country than any other country on the face of the Earth, and then perhaps what could be done. Perhaps we could start talking about rolling back some of the mistakes of Sarbanes-Oxley.

Thankfully, the debate about Blackstone IPO will not result in a public scandal. It will and has resulted in small investors able to participate in just a few thousand dollars, a few hundred shares, if they choose to, in fact, the management team of a company that has been wildly successful.

Full disclosure, not just by the SEC but also, and I think more importantly, by the public media has made it very clear that this is a unique first event and that investors should make sure that they are not over-weighted in this or any other investment.

Mr. Chairman, not to be overly colorful, but because I am a believer that America's competitiveness depends on private equity, I am going to close and put the rest in for the record and just tilt up one example. I used wine with Chairman Waxman not too long ago, but Dunkin Donuts, a small public company that went private, in my opening statement I characterize they have made it very clear that their success today, in fact, the fact that they are doing a very good job against their best-known rival, Krispy Kreme—since I am putting out public names of which I own none—they, in fact, could not have reorganized and come out a much more successful company if they didn't have the ability to come out of the daily quarterly grind, make the kinds of investments that often we on the dais complain are short-sighted, the I have to make this quarter, the next quarter that public companies often do. But instead, they were able to put together a long-term plan, come out, and, in fact—and the odor is absolutely wonderful—produce a product that now is selling dramatically better than it did just a few years ago.

Mr. Chairman, I will put the rest in for the record and make the donuts available to all of our guests. [Laughter.]

I will yield back.

[The prepared statement of Hon. Darrell E. Issa follows:]

DARRELL E. ISSA
49TH DISTRICT, CALIFORNIA

WASHINGTON OFFICE:
211 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-3906
FAX: (202) 225-3303

DISTRICT OFFICE:
1800 THIBODO ROAD, SUITE 310
VISTA, CA 92081
(760) 599-5000
FAX: (760) 599-1178
SOUTHWEST RIVERSIDE COUNTY
(951) 693-2447
www.issa.house.gov

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REPUBLICAN POLICY COMMITTEE

Domestic Subcommittee Hearing:
"Risk of Exposing Small Investors to Hedge and Private Equity Funds"
Remarks, Ranking Member Darrell Issa
July 11, 2007

Mr. Chairman, thank you for holding this hearing today so that we can take a closer look at the private equity market at a time when these organizations are beginning to open up a portion of their organization to public investment.

So little is known about the private equity industry, it is easy to mischaracterize the role they play in our economy. My comments today are directed primarily at private equity funds. I am concerned that we in Congress are lumping equity and hedge funds together and looking at them interchangeably. They are different entities and should be seen differently.

Frequently, I have heard individuals such as Steve Schwarzman of Blackstone or Lou Gerstner of the Carlyle Group characterized as "Masters of the Universe," evoking images of "Robber Barons" or "Captains of Industry" to explain this modern business model. What is more, in nearly every article covering the Blackstone IPO, there was also a description of the CEO's "lavish lifestyle." These notions have led some Members of Congress to advocate increasing the taxes associated with the private equity business model.

Now- I am a Member of Congress and I worry about tax revenues and the large public debt, and let's be honest- Mr. Schwarzman and others like him, let's say, George Soros, Mr. Hedge Fund himself and the founding member of MoveOn.org, are attractive targets for a tax increase. But Congress cannot change the fundamental assumptions underlying the private equity business model just to raise Mr. Schwarzman's taxes, without serious repercussions sending shock waves the world over. The wealth created by private equity is widely distributed throughout our economy and some of the greatest beneficiaries are pension funds and endowments.

Further, the recent characterizations of private equity are much too simplistic to accurately explain the role they have in our economy. But more importantly, these simplistic characterizations are an utterly inadequate guide for Congress as we begin to take a closer look at the business structure of these firms. This is why I support your

effort Mr. Chairman to hold these hearings so we may learn more about private equity before we move to impose additional regulations on the industry.

Too often securities legislation has been the product of a Congressional hot-house, following closely on the heels of a financial scandal or disaster. It is no coincidence that Congress passed the Securities Act in 1933 or created the Securities and Exchange Commission in 1934, following the dark days of the 1929 crash. Just recently, history repeated itself when Congress passed the Sarbanes-Oxley Act on the heels of the Enron and WorldCom disasters. However, unlike some of our nation's top CEO's and other workaholics, Congress DOES NOT do its best work under these pressure filled conditions. Too often there are unintended consequences that cost the American pubic untold amounts of money as they seek to comply with the new laws passed by Congress.

Thankfully, the debate around the Blackstone IPO is not the result of a public scandal or financial disaster. Quite to the contrary, the U.S. economy is healthy and vibrant today, partly as a result of public equity funds. What I think you will hear from our witnesses today, even those who urge greater regulatory intervention, is that private equity is a huge contributor to the continued competitiveness of the United States in the global market place.

Mr. Chairman, quite simply private equity funds are a tool that allows a company to make necessary changes in its business strategy, capital investment, or management that it would otherwise be unable to make. You see, one of the most pressing challenges that entrepreneurs face as they manage public companies is the relentless need to meet quarterly expectations, namely to follow the Harvard MBA dictum to maximize profits in the short term. The pressure to maintain a company's stock price will cause some managers to hesitate before making substantial changes to their business model, even when a change is desperately needed. Private equity is a mechanism that allows companies to re-engineer their business model, re-capitilize, and grow the company, including creating new jobs.

To paint a picture for you- I brought in this box of Dunkin Donuts, a business I believe we are all too familiar with! The reason why these pastries are relevant to today's discussion is because Private Equity groups bought the Dunkin Brands in 2006, when they were an under performing asset in a larger family of companies. The private equity firm's strategy required significant expenditures that reduced short term earnings. And just so we are clear--- for a public company,-- reduced quarterly earnings is an invitation to shareholder law suits.

However, the CEO of Dunkin Brands recently told the House Financial Services Committee that private equity enabled them to, "*make significant investments in our infrastructure ... and opened the door to opportunities that were previously beyond their reach.*" Now, Dunkin Brands expects to create 250,000 new jobs as they open new stores across the United States. This turnaround (and the 250,000 new jobs) was made possible because of the opportunity provided by private equity.

With respect to our economy, there is one lesson that will continue to reassert itself. So long as there is an honest dollar to be made, an entrepreneurial mind will figure out a way to make it. But in a dynamic economy that we Americans are so blessed to have, this is not a zero sum game. If a General Partner at Blackstone turns a tidy profit because of their investment in and reorganization of a marginal company, they are not extracting wealth from that company. Rather, Mr. Chairman, the incentives of the General Partner are aligned with the interests of their investors. Their investors- the pension plans and retirement funds - also benefit from the wealth creation, as do the individuals who own those pensions.

According to Private Equity Intelligence reports, the total net profits distributed to investors by private equity funds between 1991 and 2003 was $430 billion. Further, people not a party to the investment transaction also enjoy a benefit. As the restructured company is able to open new stores and hire more employees, a small town will benefit from additional job opportunities and the city will even have more tax revenues!

While this hearing delves into the legal issues of whether a Private Equity firm should be characterized as an investment company or whether the General Partnership should enjoy the beneficial tax characterization of capital gains, as opposed to ordinary income, we cannot lose sight of the critically important and beneficial role of private equity in our economy.

Top 20 US Public Pension Plans by Assets Under Management

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
California Public Employees' Retirement System (CalPERS)	1,500,000	230,300	21,625	9.4	13,818
California State Teachers' Retirement System*	795,000	158,000	10,371	6.5	18,960
New York State Common Retirement Fund	995,000	130,000	8,190	6.3	11,700
Florida State Board of Administration	240,000	123,000	3,379	3.0	6,150
New York City Retirement System	200,000	114,598	2,177	1.9	5,730
Teacher Retirement System of Texas	1,000,000	109,000	3,564	3.3	4,360
New York City Teachers' Retirement System	150,000	87,353	2,446	2.8	4,368
New York State Teachers' Retirement System	385,000	85,000	2,800	3.3	4,250
State of Wisconsin Investment Board	527,000	81,570	2,447	3.0	4,079
New Jersey State Investment Council	600,000	79,000	2,370	3.0	4,345
Washington State Investment Board	443,699	76,300	10,682	14.0	12,971
Regents of the University of California	n/a	71,000	3,550	5.0	8,875
Ohio Public Employees' Retirement System	670,000	67,582	607	0.9	2,703
Oregon State Treasury*	315,000	67,000	10,050	15.0	10,050
State Teachers' Retirement System of Ohio	446,500	65,500	3,657	5.6	1,965
Oregon Public Employees' Retirement Fund	300,000	60,000	5,400	9.0	7,200
Pennsylvania Public School Employees' Retirement System	410,000	57,168	5,431	9.5	6,300
Michigan Department of Treasury*	576,163	55,000	6,600	12.0	7,500
Virginia Retirement System	500,000	48,500	2,570	5.3	3,395
Minnesota State Board of Investment*	498,000	45,000	3,375	7.5	4,500
TOTAL	10.5 Million	$1.8 Trillion	$111 Billion	5.8 (average)	

*Membership numbers from fund website
Source: Private Equity Intelligence; 2007 LP Universe Survey

Exhibit 3

Who benefits from these returns? The big winners are public pension funds, university endowments, and leading foundations. Together, these funds represent the single largest group of investors in PE and collectively accounted for one-third of all capital allocated to private equity in 2006. In fact, the 20 largest public pension funds for which data is available (including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration) have some $111 billion invested in private equity, delivering strong investment returns to their 10.5 million beneficiaries. Add in corporate and some union pension plans and it becomes clear that private equity has gone to work on behalf of tens of millions of Americans. Of course, the private equity industry's executives also benefit from the returns generated by these investments. However, the perception that private equity is mainly about a handful of New York financiers doing very well at everyone else's expense is demonstrably misleading. (Exhibits 3 & 4)

Some suggest that private equity delivers its substantial returns mainly as a result of financial engineering and does little to create real-world value. In its early years, private equity firms could simply change a firm's capital structure and make considerable profits. But that is no longer the case. Winning private equity strategies must

Capital Commitments to Private Equity by Source

Percent of capital invested in PE by LP type

	[illegible]	[illegible]
Public Pension Funds	22	26.6
Corporate Pension Funds	10	12.3
Union Pension Funds	1	1.4
Banks & Financial Services	6	9.8
Insurance Cos.	12	7.5
Endowments/Foundations	10	7.7
Family Offices	11	6.8
Wealthy Individuals	10	10.1
Funds of Funds	13	13.9
Other	5	3.9
Total	100	100

*Sample size: over global 75 funds with total capital of over $32 billion

**Sample size: over global 110 funds with total capital of over $44 billion

Source: The PE Analyst 2006 Sources of Capital Survey presented in *PE Analyst*, April 2007

Exhibit 6

Who invests in private equity funds? Companies investing employee retirement savings in private equity include such household names as General Motors, General Electric and Boeing. Public and private universities, ranging from the University of California to Rice University, do the same. Public pension funds—the Washington State Investment Board and the Los Angeles County Employees Retirement Association are two—also are pursuing private equity investment opportunities. Ever since legendary investor David Swensen, who manages Yale University's endowment, made outsized returns for his alma mater by investing significantly in private equity, other institutions have followed suit. (Exhibit 6)

According to the Russell Survey on Alternative Investing, on average, public pensions commit seven to eight percent of their assets under management to private equity investments, corporate pensions commit six to seven percent and university endowments commit nine to ten percent. This does not include for-profit asset managers, whose allocations to private equity also have been growing rapidly.

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211 Cannon House Office Building, Washington, DC 20515
(202) 225-3906, (202) 225-3303 (fax)
www.issa.house.gov

For Immediate Release
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Contact: Frederick Hill
Email: frederick.hill@mail.house.gov

ISSA CRITICIZES RUSH TO JUDGEMENT ON THE PUBLIC SALE OF PRIVATE EQUITY FUNDS

Washington, DC – Rep. Darrell Issa (R-CA), one of the most successful business entrepreneurs in Congress who founded and built a NASDAQ listed consumer electronics company, today at a hearing of the House Oversight and Government Reform Subcommittee on Domestic Policy, strongly cautioned his colleagues to not confuse Private Equity Funds with Hedge funds. Issa lamented the lack of understanding in Congress about the nature and purpose of private equity funds in the business world and the enormously positive role private equity funds play in rejuvenating American companies and their central role in growing American pension and retirement funds.

"When the business community develops a successful model, this Democrat Congress will want to regulate it. If it continues to succeed they want to tax it," said Issa. "Democrats are attempting to confuse the public by combining apples and oranges. Private Equity Funds and Hedge Funds are fundamentally different."

While publicly traded companies tend to focus on creating immediate profits, Private Equity Funds typically purchase mature businesses that are underperforming or that have the potential to outperform current expectations. Following the purchase of such a business, Private Equity Fund Managers focus on long-term efforts to maximize the value and operations of a company rather than immediate profits. Private equity funds typically own these targeted businesses for several years before reselling the revamped business.

Hedge Funds, on the other hand, are generally pools of capital invested in stocks, bonds, or commodities. They typically do not purchase a controlling interest in a company. Instead, the typical business model seeks to capitalize on short-term gains. The typical holding period for a hedge fund investment is weeks or months, and rarely years.

As an example of a successful Private Equity Fund acquisition, Rep. Issa cited the purchase of Dunkin Brands (Dunkin' Doughnuts) in 2006, that was an under-performing asset in a larger family of companies. The private equity firm's strategy required significant expenditures that reduced short term earnings. The CEO of Dunkin Brands recently told the House Financial Services Committee that private equity enabled them to, "*make significant investments in our infrastructure ... and opened door to opportunities that were previously beyond their reach.*" Now, Dunkin Brands expects to create 250,000 new jobs as they open new stores across the United States. This turnaround (and the 250,000 new jobs) was made possible because of the opportunity provided by private equity.

"Democrats have already begun discussions about new regulations and increasing taxes on Private Equity Funds – they have not made the case for why this business model should be regulated or taxed differently than other companies that decide to go public. Democrat efforts to fund their spending binge by punishing the success of a relatively new business model are misguided and contrary to the well-being of our free market economy."

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Mr. KUCINICH. I want to thank my friend for his presentation and say that we shall proceed in the spirit of keeping our eye on the donut and not on the hole. [Laughter.]

I am a vegan. I don't eat that stuff.

The Chair will recognize the distinguished Member of Congress from New Hampshire, Mr. Hodes, who is a guest at our committee.

We welcome you.

Mr. HODES. Thank you, Mr. Chairman. I appreciate your allowing me to sit as a guest member of the subcommittee. I am a member of the Oversight and Government Reform Committee and also a member of the Financial Services Committee, and am especially interested in the Blackstone matter.

I had a pleasure, as a member of the Financial Services Committee, Mr. Donahue, to question Chairman Cox and the Commissioners of the SEC about the Blackstone IPO because of some particular concerns I had.

Now, I am not here to argue between tempe and tofu or one wine or the other, and I understand that the SEC has held that the Blackstone IPO did not have to comply with the Investment Company Act of 1940.

My concern remains, however, and I suppose that reasonable minds could differ on the SEC's conclusion, and reasonable minds do, and the courts could take it up, and they may. But my question really—and I am hoping you will address this—is that it is a public policy question. The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

We are now in a new world in which a private equity firm, Blackstone, probably very different than a traditional, if such can be applied to the word hedge fund, has now gone public. They have made the transition from the private equity entity into the public markets.

In that light, according to their S–1 filing and what is generally recognized in the way they are formed, they have disclaimed fiduciary duties in general to their unit holders, they have limited voting rights to their unit holders, and they have asserted the right to act with limited disclosure as to important elements of their strategy and the way they operate which would otherwise, in the ordinary course of a public offering which did comply with the Investment Company Act of 1940, be available to their shareholders or unit holders.

I think significant public policy questions are raised, and it is not too early, given the size and complexity of the Blackstone IPO and other private equity firms which appear to be coming to the market, to ask the question whether or not, in view of this new entity, the Investment Company Act of 1940 is up to date, and whether or not amendments need to be made to respond to the new situation in the markets in order to protect investors, because for the life of me I cannot see who is protecting the investors in the Blackstone IPO if they are allowed to disclaim their fiduciary duties, and how and by what mechanism that will happen.

I understand that the SEC is moving on some elements to deal with fraud provisions that might relate, but it strikes me, as a matter of public policy, that we may have to address the Investment

Company Act of 1940, and I look forward to hearing from you your thoughts on the advisability of doing that.

Thank you very much.

Thank you, Mr. Chairman.

Mr. KUCINICH. I thank the gentleman for joining us.

If there are no additional opening statements, this subcommittee will now receive testimony from the witnesses before us today.

I want to start by introducing the gentleman who will be making the first presentation, Mr. Andrew Donahue. Mr. Donahue has been the Director of the Division of Investment Management at the Securities and Exchange Commission since May 2006.

Welcome, Mr. Donahue.

As Director, Mr. Donahue is responsible for developing regulatory policy and administering the Federal securities laws applicable to mutual funds, exchange-traded funds, closed-end funds, variable insurance products, unit investment trust, and investment advisors. You can see that we have the right person here to talk to about this.

Prior to the SEC, Mr. Donahue was global General Counsel for Merrill Lynch Investment Managers and chairman of the firm's Global Risk Oversight Committee. Prior to his time at Merrill Lynch, Mr. Donahue was a securities lawyer and executive vice president and general counsel, director, and member of the Executive Committee for Oppenheimer Funds.

Mr. Donahue, it is the policy of the Committee on Oversight and Government Reform to swear in all witnesses before they testify, and I would ask if at this time you would kindly rise and raise your right hand.

[Witness sworn.]

Mr. KUCINICH. The record will reflect that the witness answered in the affirmative.

I ask the gentleman to give a brief summary of his testimony. Keep this summary, if you would, under 5 minutes in duration. I want you to bear in mind that your complete statement and anything you want to attach to it will be included in the hearing record.

The gentleman is recognized. Again, thank you for your presence here today.

You may proceed.

STATEMENT OF ANDREW J. "BUDDY" DONAHUE, DIRECTOR OF THE DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. DONAHUE. Chairman Kucinich, Ranking Member Issa, and members of the subcommittee, I am pleased to be here today to discuss the Securities and Exchange Commission's perspective with respect to initial public offerings of investment advisory firms that, among other things, manage hedge and private equity funds.

As the head of the Commission's Division of Investment Management, I have responsibilities for overseeing and regulating nearly 1,000 investment company complexes with over $11 trillion in assets, and more than 10,000 investment advisors that manage more than $37 trillion in assets.

A number of issues have been raised about the recent IPOs of Fortress Investment Group and the Blackstone Group. I am pleased to be able to offer the committee my knowledge and expertise, especially as it relates to the question of whether Fortress and Blackstone are investment companies and thus subject to the substantive provisions of the Investment Company Act of 1940.

Congress enacted the Investment Company Act to provide a separate and different regulatory structure for investment companies as compared to industrial or operating companies. Among Congress' stated goals was to minimize the risk that an investment company might be managed in the interest of its managers or certain shareholders rather than for the benefit of all shareholders.

The Investment Company Act provides important protections to investment company investors. I have great respect for the Investment Company Act and the role that it has had in affording America's investors an opportunity to invest in our Nation's securities markets through a vehicle subject to meaningful oversight and protection. As a result, I believe investment companies' status to be a critical determination.

The staff reviewed the Fortress and Blackstone registration statements in the normal course and consistent with past review practices and Commission precedent. Applying tests established by Congress and the Investment Company Act, the staff concluded that Fortress and Blackstone do not appear to be investment companies.

First, under the orthodox investment company test, Fortress and Blackstone are primarily engaged and hold themselves out as being primarily engaged in the business of managing money for others, not themselves. Their assets, sources of income, officer and employee activities, historical development, and public statements are consistent with those of an operating company, not an investment company.

Second, in applying the inadvertent investment company test, Fortress and Blackstone did not appear to have 40 percent of their assets in investment securities.

In addition to other assets, the primary assets of Fortress and Blackstone are their general partnership interests and the underlying funds they manage. These general partnership interests raise two questions relevant to the investment company status determinations. First, are they securities or investment securities? Second, what is their value?

Under existing law, general partnership interests are not securities if the profits relating to those interests generally come from the efforts of the general partners, as opposed to the efforts of others. In the case of Fortress and Blackstone, the issue is maintained control over the day-to-day management of the underlying funds, with senior employees exercising such management through wholly owned subsidiaries.

The profits to the general partnership interest result from the efforts of the general partnership managers, not others; thus, the general partnership interest would not constitute securities or investment securities.

With respect to valuation, the Investment Company Act requires an issuer to assign a fair value to general partnership interests like

those at issue in Fortress and Blackstone filings. In determining a fair value, the right to carried interest in underlying funds may be considered, because such rights are inexorably linked to the general partnership interest.

Applying these principles, neither Fortress nor Blackstone appears to hold investment securities with a value exceeding 40 percent of total assets.

Put another way, in the context of both Fortress and Blackstone, the value of the assets that are not investment securities—the general partnership interests, including the right to receive carried interest in the underlying funds—is more than 60 percent of total assets.

This asset composition is indicative of an operating company business rather than an investment company business.

When conducting an investment company status analysis, the staff considers the status to the relevant entity prior to the offering, as well as giving effect to the offering. They also monitor the investment company status of certain companies on an ongoing basis. In some cases, the staff may disagree with the investment company's status analysis and request that it either register as an investment company or restructure its business or securities holdings so as to no longer be an investment company. The Commission will bring an enforcement action against a company in appropriate circumstances.

Our staff did not object to the investment company status conclusion in the Fortress and Blackstone registration statements. As noted in the required legends on all registered public offerings, the Commission does not approve or disapprove of the securities offered, nor does it pass upon the adequacy or accuracy of the disclosures. Fortress and Blackstone remain liable for the statements contained in their registration statements.

Finally, it is important to consider that the public investors in Fortress and Blackstone are buying an interest in an ongoing business which, among other things, manages some underlying funds. While the value of their investment in Fortress or Blackstone may be related to how well Fortress or Blackstone do at managing those underlying funds, as well as how well Fortress and Blackstone are operating their business, investors are not acquiring a share in any underlying fund.

Thank you for this opportunity to appear before the committee. I would be happy to answer any questions you may have.

[The prepared statement of Mr. Donahue follows:]

Testimony Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds

Andrew J. Donohue
Director, Division of Investment Management,
United States Securities and Exchange Commission

Before the Domestic Policy Subcommittee

of the Oversight and Government Reform Committee

U.S. House of Representatives

July 11, 2007

Chairman Kucinich, Ranking Member Issa, and Members of the Subcommittee:

I am pleased to be here today to discuss the Securities and Exchange Commission's perspective with respect to initial public offerings of investment advisory firms that, among other things, manage hedge and private equity funds. As the head of the Commission's Division of Investment Management, I have responsibilities for overseeing and regulating nearly 1,000 investment company complexes with over $11 trillion in assets and more than 10,000 investment advisers that manage more than $37 trillion in assets, as well as administering the federal securities laws applicable to registered investment companies (including mutual funds) and investment advisers.

A number of issues have been raised about the recent IPOs of investment advisory firms that, among other things, manage hedge and private equity funds ("alternative asset managers"), specifically the offerings by Fortress Investment Group LLC ("Fortress") and The Blackstone Group L.P. ("Blackstone"). I am pleased to be able to offer the Committee my knowledge and expertise, especially as it relates to the question of whether alternative asset managers are investment companies and thus subject to the substantive provisions of the Investment Company Act of 1940 (the "Investment Company Act").

Relevant Law for Investment Company Act Status Determinations

Congress enacted the Investment Company Act to provide a separate and different regulatory structure for investment companies, as compared to industrial, or operating, companies. Among the Congress's stated goals was to minimize the risk that an investment company might be managed in the interests of its managers or certain shareholders rather than for the benefit of all shareholders. Unlike operating companies, investment companies are subject to comprehensive substantive requirements in areas such as: limitations on capital structure, *e.g.* borrowing restrictions; limitations on the ability to transact business with affiliates; and limitations on how the investment company must maintain custody of fund assets. Investment companies also are required to maintain specific books and records, which are subject to examination by the

Commission. Section 3 of the Investment Company Act has two main tests for determining whether an issuer is an investment company:

- The first test is whether the issuer is primarily engaged (or holds itself out as being primarily engaged) in the business of investing in securities. (*See* section 3(a)(1)(A) of the Investment Company Act.) This "orthodox investment company" test defines issuers that hold themselves out, or otherwise are clearly recognizable, as investment companies.
- The second test is whether the issuer (a) is engaged in the business of investing, reinvesting, owning, holding, or trading in securities and (b) owns investment securities, the value of which exceeds 40% of its total assets. (*See* section 3(a)(1)(C) of the Investment Company Act.) Companies that fall within this "inadvertent investment company" test are often referred to as inadvertent or prima facie investment companies, presumably because they view themselves as industrial or operating companies rather than investment companies.

The Investment Company Act provides a number of exclusions from these tests for certain companies that appear to meet one or both of the tests but that Congress believed should not be regulated as investment companies. Notably, section 3(b)(1) excludes a company that is engaged primarily in a business other than investing, reinvesting, owning, holding or trading in securities. In addition, section 3(b)(2) excludes an issuer that the Commission declares by order is engaged primarily in a business other than investing, reinvesting, owning, holding or trading in securities, and the Commission has adopted rules under this authority, such as rule 3a-1, which codifies the standards that the Commission has applied over many years in processing individual requests for orders under this section.

SEC Staff Process for Reviewing Investment Company Act Status Issues

Many of the more complex Investment Company Act status determinations arise in the context of companies that view themselves as engaged in an operating business, and not in the investment company business. Consistent with this understanding, these companies file their registration statements and periodic reports with the Commission, and these filings are reviewed initially by the staff of the Commission's Division of Corporation Finance. When an issue arises as to whether a purported operating company should be treated as an investment company, Division of Corporation Finance staff will refer the issue to the Investment Management Division. With regard to the recent IPO registration statements of Fortress and Blackstone, Corporation Finance staff did just that.

The staff reviewed these filings in the normal course and consistent with past review practices. Under the federal securities laws, an issuer of covered securities is strictly liable to investors to assure that a registration statement is in full compliance with the federal securities laws and discloses all material information that a reasonable investor would need to make an investment decision. Consequently, as noted in required legends in all registered public offerings, the Commission does not approve or disapprove of the securities being offered nor does it pass upon the adequacy or accuracy of the disclosure in the prospectus. If the staff is satisfied that the registration statement is in compliance with the federal securities laws, the staff declares the filing effective pursuant to delegated authority by the Commission, which means that the

company is allowed to engage in the transaction it has described in that registration statement. However, the issuer remains liable for the statements contained in that statement.

The staff carefully considers whether a company is an investment company in light of the definitions of investment company under the Investment Company Act and consistent with the Commission's long-standing interpretations of these definitions. The staff considers the status of the relevant entity prior to offering, as well as giving effect to the offering. They also monitor the Investment Company Act status of certain companies on an ongoing basis. In some cases, the staff will determine that the company properly is treated as an operating company. Often, these companies will include risk disclosure in the offering documents about their status under the Investment Company Act, and the consequences to their businesses if they were required to register as investment companies. In other instances, the staff may disagree with a company's investment company status analysis, and request that it either register as an investment company or restructure its business or securities holdings so as to no longer be an investment company. The Commission will bring an enforcement action against the company in appropriate circumstances.

SEC Staff Views on Investment Company Act Status of Fortress and Blackstone

The staff carefully reviewed the registration statements and other information provided by Fortress and Blackstone to determine whether they were investment companies and required to register as such under the Investment Company Act. I am pleased to provide you with the details of our analysis. As described earlier, the Investment Company Act includes two relevant tests for determining Investment Company Act status: one for orthodox investment companies, and one for inadvertent, or prima facie, investment companies.

Orthodox Investment Companies Test

As a general matter, under the orthodox investment company test, the focus is on the investment of the issuer's own assets, not the assets of others (otherwise, all investment advisers might be deemed to be investment companies).

As is described in detail in the registration statements, neither Fortress nor Blackstone is an orthodox investment company. Fortress and Blackstone are engaged primarily (and hold themselves out as being engaged primarily) in the business of providing asset management and financial advisory services to others and not primarily in the business of investing in securities with their own assets. In its registration statement, Fortress described itself as a "global alternative asset manager ... We raise, invest and manage private equity funds, hedge funds and publicly traded alternative investment vehicles." In its registration statement, Blackstone described itself as a "global alternative asset manager and provider of financial advisory services" whose "businesses include the management of corporate private equity funds, real estate opportunity funds, funds of hedge funds, mezzanine funds, senior debt vehicles, proprietary hedge funds and closed-end mutual funds" and whose business also includes the provision of "various financial advisory services, including corporate and mergers and acquisitions advisory, restructuring and reorganization advisory and fund placement services."

The Commission traditionally assesses the "primary engagement" of a company by examining the composition of its assets, sources of its income, the investment activities of its officers and employees, the company's public statements, and its historical development in order to compare the securities and non-securities businesses of the company. Also, the Commission traditionally considers the nature of the assets and income to be the most important factors in this analysis.[1]

Based on the analysis described in the section below (see "Inadvertent Investment Companies Test"), we determined that the assets of Fortress and Blackstone are primarily indicative of an operating, and therefore non-investment company, business.

We believe that the other factors that form the basis for the "primary engagement" test provide further evidence that Blackstone and Fortress are engaged primarily in the business of managing money for others, and are not primarily in the business of investing for themselves. In each case, their income and revenues are primarily derived from their asset management business and not from their own investments; they hold themselves out as money managers and not as investors or investment companies; and they spend most of their time managing others' money, not their own.

As a result, the staff concluded that Fortress and Blackstone appear to be primarily engaged in a non-investment company business.

Inadvertent Investment Companies Test

With respect to determining whether Fortress or Blackstone would constitute an inadvertent investment company, the key test established by Congress in the Investment Company Act is whether more than 40% of a company's assets are investment securities.[2]

Alternative asset managers typically have a variety of assets. In the case of Fortress and Blackstone, as is described in their registration statements, the main assets relevant to the inadvertent investment company test are the general partnership and limited partnership interests in their underlying funds. While limited partnership interests are treated as investment securities, under existing law, general partnership interests are not securities, if the profits relating to those interests generally come from the efforts of the general partners, as opposed to the efforts of others.[3] In the case of Fortress and Blackstone, the issuers maintain control over the day-to-day

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1 *Tonopah Mining Company of Nevada*, 26 SEC 426 (1947).

2 Although the meaning of "securities" under section 3(a)(1)(A) is different than the meaning of "investment securities" under section 3(a)(1)(C), those differences are not relevant to the analysis of Fortress and Blackstone.

3 *See, e.g., Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1980). For example, a general partnership interest can be designated a security if the investor can establish that: (1) an agreement among the parties leaves so little power in the hands of the partner that the arrangement in fact distributes power as would a limited partnership; (2) the partner is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership powers; or (3) the partner is so dependent on some

management of the underlying funds, with senior employees exercising such management through wholly owned subsidiaries. The profits to the general partnership interests result from the efforts of the managers, not others, and the general partnership interests would thus not constitute securities. The fact that the public investors in the securities sold by Fortress and Blackstone have no voting rights with respect to the management of the underlying funds would not change this conclusion. Thus, the general partnership interests would not be securities and therefore not "investment securities" for Investment Company Act purposes.

After determining which assets should be treated as securities and which as non-securities, a value must be assigned to each. The Investment Company Act requires that in making these valuations, an issuer must assign a fair value to general partnership interests like those at issue in the Fortress and Blackstone filings. In order to make such a valuation, an alternative asset manager may consider, among other things, its right to "carried interest" in the underlying funds. This right, which is part of the compensation for managing the underlying funds, entitles the manager to share in the profits of the underlying fund. Typically, an underlying fund must return the capital given to it by limited partners plus any preferential rate of return before the manager can share in the profits of the fund. The manager will then receive a carried interest, which is calculated as a percentage of the profits. Fortress and Blackstone calculate the fair value of their general partnership interests in the underlying funds to include their rights to receive carried interests because such rights are inexorably linked to the general partnership interests.

Applying the principles laid out above, the Division of Investment Management staff concluded that neither Fortress nor Blackstone appears to hold investment securities with a value exceeding 40% of total assets. Put another way, in the context of both Fortress and Blackstone, the value of their "investment securities," (*i.e.,* their limited partnership interests in the funds that they manage and their other securities investments) is less than 40% of total assets. Conversely, the value of the assets that are not "investment securities," (*i.e.,* the general partnership interests, including the right to receive carried interests in the underlying funds) is more than 60% of total assets. This asset composition is indicative of an operating company business, rather than investment company business.

Even if the staff concluded that Fortress or Blackstone held investment securities with a value exceeding 40% of total assets, those entities may have been able to rely on certain exclusions from the definition of investment company under section 3. In particular, section 3(b)(1) of the Investment Company Act excludes a company if it is engaged primarily in a business other than investing in securities. Under section 3(b)(1), the analysis of the entity's primary engagement is similar to that discussed above.[4] In addition, Commission rule 3a-1, which modifies the traditional 40% asset test in certain ways, may also have been available to these entities.[5]

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unique entrepreneurial or managerial ability of the manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers. *See id.*

4 *See* Fortress registration statement, at p. 48 (Feb. 9, 2007); (Blackstone registration statement, at p. 60-61 (June 25, 2007).

5 *See* Fortress registration statement, at p. 48 (Feb. 9, 2007).

Two final notes about the analysis performed by the Commission's staff: First, both Blackstone and Fortress included disclosure in the risk factors section of their offering documents regarding potential uncertainty relating to whether they might be deemed to be investment companies under the Investment Company Act, and the impact that registration under the Investment Company Act could have on their businesses. Second, each has an opinion of counsel stating that it is not an investment company.

Finally, it is important to consider that the public investors are buying a share of the entity managing these funds, rather than a share in the underlying funds. Thank you for this opportunity to appear before the Committee. I look forward to working with you to meet the needs of our nation's investors, issuers, and markets, and I would be happy to answer any questions you may have.

Mr. KUCINICH. I thank the gentleman.

I would like to start out by asking you, sir, can you tell the committee what are some of the investor protections that follow if an offering is determined by the SEC to be an investment company?

Mr. DONAHUE. There is a broad array of investor protection built into the 1940 act. There are limits on the composition of the board of directors, there are certain approvals that must be made by the board of directors of the investment company. There are provisions that cover the valuation of the assets that are owned by the investment company. There are limits on borrowing, senior securities, and leverage. There are limits on what the capital structure can be. There are limits on affiliate transactions. There are limits on where assets can be custodied. And there are very specific requirements with respect to who the advisor and who the officers and employees can be for the investment company.

Mr. KUCINICH. Thank you. Now, in view of the Securities and Exchange Commission determination that Blackstone LP was not an investment company, what investor protections exist now?

Mr. DONAHUE. The investor protections that exist now for investors investing in Blackstone and in Fortress are those that are available to investors in securities that are registered with the Securities and Exchange Commission that are not investment companies.

Mr. KUCINICH. Let me be more specific, if I may. Under this determination that Blackstone LP was not an investment company, do investors have a right to an independent board of directors?

Mr. DONAHUE. The composition of the board of directors for that entity, same as for other 1933 Act companies, would be determined by a combination of State law and the listing requirements of the exchange that they are traded on.

Mr. KUCINICH. So you can't answer yes or no? Is that what you are saying?

Mr. DONAHUE. I believe in the case of Blackstone that three of their seven directors will be independent. That is my understanding.

Mr. KUCINICH. OK. Three of seven. Do they have guaranteed voting rights under this?

Mr. DONAHUE. They have the voting rights that are afforded to them under their governing documents and State law and Exchange rules, same voting rights as any other 1933 Act company, same limitations.

Mr. KUCINICH. Do they have protections against self-interested transactions with affiliates?

Mr. DONAHUE. Not under the Investment Company Act, but they would have the same protections that might be afforded to other registered companies.

Mr. KUCINICH. Do they have the guarantee of protections of the traditional range of fiduciary duties owed by management to shareholders in a corporation such as a duty of loyalty?

Mr. DONAHUE. They would have the duty that is determined under State law.

Mr. KUCINICH. Now, may I ask you, are hedge funds and private funds sold today to ordinary investors? If not, why not?

Mr. DONAHUE. The hedge funds and private pools of capital, private funds, can be sold currently to investors, provided that they are done in accordance with the—generally they use Regulation D, and in order to avoid registration under the Investment Company Act they generally comply with the exception under either 3(c)(1), where there are under 100 investors, or 3(c)(7), where there is unlimited number of investors that all meet the $5 million or higher test for investments.

Mr. KUCINICH. Does the case law in applying the Securities and Investment Company Act generally support the principle that function trumps form, or the converse?

Mr. DONAHUE. As I look at our responsibilities in administering the securities laws, we are mindful of the statutory framework within which we have been charged to operate by Congress, and determinations that have been made by courts with respect to interpretations. If there is anybody that felt that this was an investment company in our area, the protection of investors, we would have sought to see whether or not there was a way. If we felt that this had been constructed in a way to evade the Investment Company Act, we certainly would have taken, I wouldn't say a different look at it, but you can't evade the Investment Company Act. We did not feel that was the case here.

Mr. KUCINICH. I am going to ask one more question and then we will probably need to go another round. Will a significant portion of the value of the units of shares offered to the public in the Fortress or Blackstone LP deals ultimately be determined by the returns garnered under the underlying hedge fund and private equity fund portfolios and move in unison with the fund portfolios?

Mr. DONAHUE. I would start off by saying I believe in the case of Blackstone that they have over 100 underlying investment funds that it is managing. I would think that the stock price of Blackstone is going to be driven by a variety of forces. One certainly I would hope would be how well they would manage their businesses and how well they are managing their underlying funds.

It is true that, as currently constituted, a fair amount of their earnings are derived from how well they manage those underlying funds, but they are not parting company. They can go into other businesses. They can create new funds. So going forward, a lot is dependent not just on their current investments, the funds that they are managing, but also on how well they run their management, how well they manage their company.

Mr. KUCINICH. OK. Thank you very much, Mr. Donahue.

The Chair recognizes Mr. Issa. Thank you.

Mr. ISSA. Thank you. I want to continue along the line the chairman was doing. I find this very interesting.

If for a moment, instead of the IPO being about Blackstone Group, LP, if you were, in fact, investing in Dunkin Donuts, Hilton Hotels, Linens and Things, as typically people have, they are investing as limited partners, normally, correct?

Mr. DONAHUE. I am not familiar with——

Mr. ISSA. Their underlying funds are, in fact, typically Blackstone's——

Mr. DONAHUE. The underlying funds are typically set up as limited partnerships.

Mr. ISSA. Right.

Mr. DONAHUE. Yes.

Mr. ISSA. And these are sophisticated buyers, usually, if there are more than 100 of them, and they go in with a portion of their otherwise high net worth. Many of them, of course, are public entities and pension funds. And they go in knowing that they will have absolutely no control; isn't that true? That limited partners are just what it says, they are limited, they are in for the ride and for the most part are delineated with relatively little control, virtually none of the protections that the chairman talked about?

Mr. DONAHUE. I would hope they appreciate that.

Mr. ISSA. OK. So that wasn't what was offered by the SEC or reviewed by the SEC. You were reviewing something that had comparatively a little more protection; would that be fair to say?

Mr. DONAHUE. I would say it had considerable disclosure with respect to the entity that was being——

Mr. ISSA. Thank you. I stand corrected. That really is more accurate, better disclosure. However, in the public disclosure it was made clear that 78 percent of the interest in this entity belongs to the partners of Blackstone, the managers, the people who have made this a successful entity, and only 22 percent was being offered to the public, and of that, half was going to one investor, China. The other half, 11 percent of this interest, was going to the public. Is that roughly right, as you recall?

Mr. DONAHUE. As I understand it, yes, sir.

Mr. ISSA. So there is inherently a, "We are going to give you 11 percent of what we get, and the 78 percent is going to go to us, the managers, and we are going to be in it with what they like to call in the industry our skin, because we are going to try to maximize our profits." Is that essentially what this offering was all about?

Mr. DONAHUE. I don't want to characterize what the offering was all about, but certainly the sale of the units to public investors was enabling the public investors to share in the success of the operating company that they had.

Mr. ISSA. Now I am going to call your attention to those things that you can't possibly read over there, even though we made them as large as possible.

Mr. KUCINICH. Would the gentleman yield? Is there a way, if you have those on a transparency, maybe we could put them up.

Mr. ISSA. We will make it available. I will just characterize it until they get it up on the slide.

Public entities such as the Ohio Teachers Retirement, California's PERS and STERS, both the teachers and the public employees, they are typically running from 5 to 15 percent of their portfolio in private equity. For purposes of, I think, the public and Members here today, those percentages show that, in fact, private equity is something that you might want to have some of, but you wouldn't want to necessarily have only that. Is that fair to say, from your experience, because I am calling on your private life in addition to your current job.

Mr. DONAHUE. If I could answer from my prior life and not my current responsibility——

Mr. ISSA. Your prior life would be fine. You are an expert in that area.

Mr. DONAHUE. Well, I don't know that I would characterize myself as an expert, but certainly certain asset classes—and I think private equity is in there—for purposes of diversification, having a portion of your investments in those types of investments may be appropriate for you, depending on your circumstances.

Mr. ISSA. And I am going to need a second round, too, but I will just do one more on this round and then we will come back to some of the other details.

When Goldman Sachs went public, Senator Corzine, now Governor Corzine, or, as we call him Seatbelt Corzine around here—he is going to be an advocate for seatbelt safety, I am sure—made at least $233 million on that public offering. Would you, for our edification, characterize why Goldman Sachs was one type of entity, why Blackstone is another type, and how, if you are familiar with both of these, how you would deal with it. I realize that you were a Merrill Lynch guy, but you may have looked over your shoulder at Goldman Sachs at some point. I think that will help us in understanding what an investment company is, etc.

Mr. DONAHUE. This is based on imperfect knowledge. I would first say that many indeed would have loved to have been at Goldman Sachs when they went public, but the businesses of Goldman Sachs—investment banking, global market trading, asset management, and brokerage—are businesses that are traditional investment banking brokerage type businesses. A portion of what they do would be in the realm of what Blackstone and Fortress do, so they would have units that would do similar things, but it wouldn't be, obviously, as much of the particular entity as exists in a Blackstone case, the way I would characterize the differences there.

Mr. ISSA. OK. And that was where the 40 percent threshold and these other considerations makes it black and white as to how you would deal with an entity like Goldman Sachs, even if they were not a corporation, but Goldman Sachs versus Blackstone.

Mr. DONAHUE. With respect to Goldman Sachs, I truly believe that the status determination would have been simpler, obviously, than Blackstone or Fortress.

Mr. ISSA. OK. Thank you.

Mr. Chairman, I look forward to a second round.

Mr. KUCINICH. Thank you very much.

The Chair recognizes Mr. Hodes.

Mr. HODES. Thank you, Mr. Chairman.

Mr. Donahue, thank you for that testimony. I marvel at your skill and the careful distinctions you made when answering Chairman Kucinich's question in referring to the rights that Blackstone would have under, say, the law of Delaware under which they are organized.

It is my understanding that in significant instances the law of Delaware also allows those registered under its laws to, by contract, essentially disclaim various of their obligations.

For instance, in this case Blackstone has limited voting rights and giving its investors no rights to elect board members, according to its S–1 filing with the SEC. This is a restriction and all of these are restrictions of rights generally available to shareholders of what we will call normal publicly traded companies. They have disclaimed their fiduciary duty to investors and limited the remedies

available. They have required a super majority vote to remove general partners. They prohibit shareholders who own more than 20 percent of outstanding common units from voting on any matter. They limit the unit holders rights of appraisal if Blackstone is reorganized. And approval from Blackstone's Conflicts Committee will be conclusive, despite Delaware law stating that this approval will simply shift the burden to a plaintiff to show a conflict of interest.

They go on. There are other disclaimers. I have just listed a partial listing of the disclaimers that Blackstone makes. So they have disclosed the multitude of ways in which they limit the rights of those who are investing in their company.

I would like you to change baseball caps for a moment to your far-sighted view as a regulator with vast experience and far better than I to look forward.

Do you agree or disagree that when a company such as Blackstone or any company sells its shares to the public, that there is a public policy implication that kicks in to provide or that should provide protection for the investors who are now no longer limited to those millionaires and multi-millionaires who are qualified investors, whether at a $1 million or $5 million level, but are not Ma and Pa, my constituents in New Hampshire investing in various ways who do not read SEC disclosure statements, who do not know what Blackstone is, and who are now trying to invest? Do you think the public policy kicks in and that we need to protect those investors?

Mr. DONAHUE. Protection of investors is certainly key to the responsibilities that the Securities and Exchange Commission has. Traditionally, for non-investment companies and 33 Act registered companies, those types of issues have been left to State law and left to the listing exchanges for their determinations. And the 1933 Act is a disclosure statute. It is, for the very reason that you could state all of those what you might characterize as non-protections, is what the 1933 Act is about, which is to make those material disclosures to investors so that investors can make an informed judgment about whether or not to make those investments.

We are not in the 1933 Act context; we are in the 1940 Act context, really merit regulators or disclosure regulators. That is the context within which we review and allow registration statements to go to the light.

Now, whether I have concerns about investor issues within certain companies and about remedies that might be to investors, of course I do.

Mr. HODES. Understanding your role as the SEC regulator on the disclosure requirements, do you have concerns on behalf of the investors in the Blackstone offering?

Mr. DONAHUE. In the Blackstone context, I believe that the review that was done by my brethren in the Corporate Finance Division, that they felt that all the material disclosures were made. They had no reason to believe that the information was not out there for investors and their advisors to make a choice of whether or not this is an investment that they should want to make.

Mr. HODES. Thank you. I see my time is up. Thank you, Mr. Chairman.

Mr. KUCINICH. The Chair will recognize Mr. Braley.

Mr. BRALEY. Thank you, Mr. Chairman.

Mr. Donahue, I want to talk to you a little bit about the SEC's mandating of Blackstone's disclosure questions. Does the SEC's judgment about whether Blackstone LP is an investment company make that determination binding upon courts who are interpreting the legal implications of such a determination?

Mr. DONAHUE. My answer to that would be no, that courts have at times disagreed with determinations that we have made.

Mr. BRALEY. And, in fact, isn't it true that just last year the 7th Circuit Court of Appeals disagreed with the SEC's interpretation of the Investment Company Act determination?

Mr. DONAHUE. I assume you are referring to the National Presto case?

Mr. BRALEY. Yes.

Mr. DONAHUE. The SEC believed that National Presto was an investment company under both the traditional test, the orthodox test, and the inadvertent test, and the court did disagree with us.

Mr. BRALEY. Could you share with us the practical impact of the ability of Blackstone LP to conduct its business and the value of the units offered to the public if a court determined that Blackstone was an investment company?

Mr. DONAHUE. It is a difficult question for me to answer in my current role, but the structure they have, the way that they operate would not be, in my judgment, practical under the 1940 Act.

Mr. BRALEY. Would it be possible that it would impose a substantial obstacle to the ability of the company to conduct its business?

Mr. DONAHUE. In my judgment it most likely would.

Mr. BRALEY. Could cause the value to fall precipitously?

Mr. DONAHUE. I am sorry?

Mr. BRALEY. Could it cause the value to fall precipitously?

Mr. DONAHUE. That is beyond my expertise.

Mr. BRALEY. All right. Did SEC staff request further explanations from Blackstone regarding its finances, including the partnership asset composition, in order to make a determination whether Blackstone LP was an investment company?

Mr. DONAHUE. If you don't mind, I will expand a little bit on it, because this is really an important determination. We didn't take the registration statement, the information contained on it, and from that just say, OK, the company says they are not an investment company. There was much back and forth between us trying to get more information about exactly what the various components were, really how the assets were being determined, and how they reached their determination that they did not believe they were investment companies.

It is difficult to, picking up a registration statement, on its face, to be able to tell that without getting more of the detailed information from the company about the valuations and a number of other things that go into that determination.

Mr. BRALEY. Did the SEC view the information as being material in making its decision on the Investment Company Act?

Mr. DONAHUE. The information supplied to us by the companies was critical for us to be able to determine that their determination of the status was not accurate, yes.

Mr. BRALEY. And was this further information about its asset composition disclosed to the public before the IPO became effective?

Mr. DONAHUE. There were some aspects of that information that was in the registration statement, and there was a certain amount of that was sent to us with a request to keep it confidential, so it was not in the registration statement.

Mr. BRALEY. Well, can you quantify for us, in terms of the volume of information that was supplied that was actually made public?

Mr. DONAHUE. Well, the first thing I would like to point out is we have a registration statement that is available, but the correspondence that goes back and forth between the registrant and the SEC are made public unless there is an appropriate request for confidential treatment.

Mr. BRALEY. When you say they are made public, in what format are those made available to potential investors?

Mr. DONAHUE. The actual letters are available on the EDGAR Web site, which is the official Web site for the SEC.

Mr. BRALEY. So is that something that a potential investor could easily access as part of their own due diligence?

Mr. DONAHUE. That would not work well for the due diligence that an investor might do in participating in the initial public offering, because the initial public offering will have already concluded by the time that correspondence is up.

Mr. BRALEY. Thank you. Those are all the questions I have.

Mr. KUCINICH. I thank the gentleman.

The Chair recognizes Ms. Watson.

Ms. WATSON. Mr. Chairman, I missed the first part of the testimony, so I am going to kind of work backward to inform myself, but, Mr. Donahue, in the Senate Finance hearing this morning, Congressional Budget Director Peter Orszag testified directly before your testimony and said that he viewed carried interest as partly compensation for return on capital and partly compensation for services rendered.

In his testimony, he also referred to a large body of academic literature discussing the issue, and other witnesses testified that carried interest differed from earnings based on service.

Do you agree with this conclusion, with Mr. Orszag's conclusion?

Mr. DONAHUE. I haven't had an opportunity to look at the academic studies that he was referring to. I would note that his testimony was being given, I believe, in the context of a hearing relative to the appropriate tax treatment of carried interest, so I don't have a view toward that.

Ms. WATSON. Well, the SEC, as I understand, has determined that Blackstone is a carried investment or carried interest and doesn't come under the Investment Company Act. Can you comment on that?

Mr. DONAHUE. I think the carried interest winds up to be an element in our determination of whether or not the nature of its investments, whether it meets the definition of an investment company. The carried interest analysis goes into the carried interest being part of the general partnership interest. Whether the carried interest entitles the general partner to receive income or whether it entitles the general partner to receive it in another form, it is

tied in to the general partnership interest, I don't believe our analysis would differ, and particularly not based on the appropriate tax treatment of it.

Ms. WATSON. Well, if Blackstone is selling publicly, there are some things that are of concern to me, and this is an area that I don't have a lot of expertise, but looking at it from afar, at least if it conformed to the Investment Company Act it would have to keep the investors well informed, it would have to compensate or have returns on their dollars a little differently, and also what would the protection of the investors be like without coming under the act.

That is a concern to me. The investors cannot vote. I guess there are no public meetings once a year. Therefore, they can do whatever they want with management, they can raise their salaries, they can give them huge bonuses, and they don't have to give them full reimbursement for their investments.

So I am wondering what your view is, having them determined as being a direct investment group and not under the act.

Mr. DONAHUE. I would like to start my response by saying that I am a great fan of the Investment Company Act. I think it provides great investments for investors. Our analysis that we start off with recognizing those great benefits, the key question that we first have is: is this an investment company? If it is not, then we don't move to push it into the investment company framework in order to get those benefits.

The threshold question is, and the charge we have gotten from Congress, is to determine whether or not these are investment companies. If they are, they are in the investment company structure, for better or worse with respect to what it is going to do with respect to how their business operates. And if they are not, then they are not investment companies and are not entitled to the protections of the Investment Company Act.

Ms. WATSON. Well, what are you going to determine on your way to making a decision? Can you give us a heads-up?

Mr. DONAHUE. On the two determinations——

Ms. WATSON. Yes.

Mr. DONAHUE [continuing]. With respect to Fortress? We will look at what their real business is, how they characterize their business, what the nature of their assets are, where the five factors that are really set up and are extraordinarily old paced, and these are asset management companies. They happen to be managing alternative type investments, but these are asset management companies.

If you look at Blackstone, I believe Blackstone has over 100 different investment vehicles that they are managing. I believe if you look at Fortress, has over 20 different investment vehicles that it is managing. They are in the business of managing other peoples' money, not in the business of managing their own money. Now, their success may very well be related to how well they do at their business of managing other peoples' money.

Ms. WATSON. Well, if you walk like a duck and you quack like a duck, most people think you are a duck, so I would be interested——

Mr. DONAHUE. Am I a duck?

Ms. WATSON. I would be interested in your determination. I will look forward to a hearing about that.

Thank you so much, Mr. Chairman. I yield back my time.

Mr. KUCINICH. I thank the gentlelady.

The Chair recognizes Mr. Cannon.

Mr. CANNON. I thank you, Mr. Chairman. I apologize. We have another hearing going on in Judiciary next door and I am a member of that panel, so I apologize for not having been here for your testimony prior to this.

Pursuing this investment question, how many comments did the SEC receive regarding the classification of Blackstone as an investment company? And how did the SEC respond to the views of these comments?

Mr. DONAHUE. I am aware of two letters we received from one entity raising questions regarding the status determination, and also aware of a letter or two that we actually received from Congress asking us questions relating to those determinations. I took those seriously. If we get correspondence coming in to us that raises questions about whether or not we are analyzing something appropriately, whether or not we are taking into account the right circumstances, whether or not we might have it wrong, I take those seriously. I want to get it right, and so we do take them seriously.

Mr. CANNON. So did you evaluate those letters and the claims in light of the statute and, I take it, determined that it is not an investment company?

Mr. DONAHUE. When we got those, one of the first things that I did with them was to send those letters to my professional staff, the senior staff that actually were the main people that were looking into the appropriate treatment of the status of these two entities, Blackstone in particular, so that they were aware, and told them that I, you know, want them to take it into account and to be in a position to discuss with me why our analysis might differ, and, if so, why we are correct.

Mr. CANNON. So you have a statutory decision about what an investment company is, with some exemptions. I take it these letters didn't lead you to believe or your staff to believe that the exemption should qualify and that this should not be an investment company?

Mr. DONAHUE. It didn't lead us to believe that Blackstone or Fortress, although I don't believe we got comments on Fortress, that either one would require an exemption from the SEC to qualify as not being an investment company.

Mr. CANNON. Let me just see if I understand it right. Even if your analysis had determined that Blackstone was an investment company, it would still likely have fallen under the statutory exemptions to an investing company? Have I gotten that correct?

Mr. DONAHUE. If the determination had been that Blackstone met either the orthodox investment company test or the inadvertent investment company, then they would have had to search for a reason why those analyses wind up being overridden. There is an analysis that they could do under a different section that their primary business is not that and is else, or they could apply for an exemption from the SEC from or determination that they are not

an exempted. They did not seek a determination that they were not.

Mr. CANNON. And they didn't need to because you had already made the determination that they are not?

Mr. DONAHUE. We concluded that they were not an investment company.

Mr. CANNON. Could you explain the key distinguishing characteristics between a mutual fund and an organization like Blackstone LP?

Mr. DONAHUE. Well, simply I would start off by saying that an investment company is in the business of managing its money, money that comes from individual investors, and in the investment company framework their capital structure is very simple. You wind up generally with one class of shares, similar rights, and the assets are valued under net asset value, and that determines what you get for your shares if you buy them or sell them, if it is an open-end fund. And there are a lot of controls built around how that money can be managed, what affiliated transactions can take place, and a lot of things.

In the case of Blackstone and in the case of Fortress, they were not investing their money. They were managing other peoples' money. They were more akin to the investment advisor to a mutual fund than they were to a mutual fund. In fact, Blackstone I believe was the investment advisor to two closed-end funds as part of its business.

Mr. CANNON. Thank you.

Mr. Chairman, may I ask how much time I have remaining? It seems like the clock is running very long.

Mr. KUCINICH. Take another minute. Go ahead.

Mr. CANNON. Thanks. I would be happy to yield.

Mr. KUCINICH. Go ahead.

Mr. CANNON. I yield that minute to Mr. Issa.

Mr. ISSA. Perhaps I can bring some clarity through a question. If we look at an architectural firm and they take on huge jobs like building the new center here, the new visitors' center at the Capitol, and they derive revenue from it, and maybe even a bonus if they do a good job and it comes in under time and under budget, which is not true of our visitors' center, as you know—there will be no bonus earned there—but, in fact, if that partnership chose to go public, it would be akin to Blackstone. It drives its revenues by its management or activities of its team, and you are investing in that team, in the revenue stream that team earns.

Is that a fair similarity, so that we get off of the model of are you a mutual fund or are you this other? Isn't that really akin to, if you were evaluating that architectural firm with all kinds of activities, including land acquisition on behalf of clients and lots of stuff, it makes it look complex, but ultimately you are investing in the management team; isn't that right?

Mr. DONAHUE. I think that is a correct analysis. From your description, it sounds like an operating company. I would need to know, to make that determination—and this is, you know, the process that we wind up going through—I would need to know what degree of investments they might have. By way of example, if they had considerable amount of investments that were in investment

securities, even though they are also in this other business they may be treated as an investment company.

Mr. ISSA. Right. And I will yield back, but the reason I asked that question is you seem to have the tools to make this evaluation of Blackstone like other companies, and these tools have served the SEC well for many, many years, and Blackstone is no exception; is that right?

Mr. DONAHUE. That is correct.

Mr. ISSA. Thank you.

I yield back.

Mr. KUCINICH. The Chair recognizes Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman. I would like to just claim my time for the purposes of yielding to Mr. Kucinich.

Mr. KUCINICH. I thank the gentleman.

Mr. Donahue, in his written testimony Professor Coffee recommends that, in light of the Blackstone LP offering, the Securities and Exchange Commission used its influence to pressure the New York Stock Exchange and NASDAQ to change its listing requirement to require that publicly traded partnerships provide the same basic corporate governance protections for public investors that are demanded of public corporations. Do you support this recommendation?

Mr. DONAHUE. I thought it was a very thoughtful analysis and appreciation for the position that the SEC is in. I have not had an opportunity to discuss Professor Coffee's recommendation with the chairman or with any of the Commissioners.

Mr. KUCINICH. Thank you. Now, with your broad jurisdiction in investor protection, as a matter of policy does the SEC have a problem that investors in these funds are denied basic corporate governance protection, such as being owed fiduciary duties, an independent board, and meaningful voting rights?

Mr. DONAHUE. First I would like to note that the investors are the investors in the operating company, and I think I am not aware of any particular problems that have arisen yet with respect to this, and I will discuss the issue with my brethren over in corporate finance that oversee public companies and see whether or not there have been issues in similar companies.

Mr. KUCINICH. Doesn't the Securities and Exchange Commission have a regulatory role beyond that of simply enforcing the Securities Act and the Investment Company Act?

Mr. DONAHUE. Well, our primary role is in enforcing the securities laws.

Mr. KUCINICH. Do you want to elaborate on that a little bit?

Mr. DONAHUE. We, as an agency, you know, should be enforcing the Federal securities laws to the best of our ability to protect investors. With respect to other issues, and some issues that might arise under State laws, some remedies that people may have contractually, that is not necessarily in our mandate unless there is fraud taking place. We have broad authority, but, once again, that is pursuant to the Federal securities laws.

Mr. KUCINICH. The reason why I ask that, of course, is, I am sure you remember Chairman Levitt, who believed that it was a proper role when he, you know, created the discussion about the

exchanges on corporate governance requirements. I am just trying to see how the SEC currently——

Mr. DONAHUE. That is a distinction there, I think, and I wasn't at the SEC when the event being referred to taking place occurred, but, having heard the characterization of it, I would look at that as the SEC taking a leadership role with respect to going to others that had responsibility and could, you know, implement changes, and suggesting that, for the protection of investors, change might be necessary.

Mr. KUCINICH. Would you agree that it is a significant question, though, whether or not the Securities and Exchange Commission sees itself as having a regulatory role in addition to enforcing the Securities Act and Investment Company Act?

Mr. DONAHUE. I view us as protecting investors, among other things. We have a mandate. Part of it is protecting investors. Others is to promote capital formation and provide for orderly markets, so we have a broad mandate and we do exercise it.

Mr. KUCINICH. Thank you.

First of all, I want to thank you for your participation. It is very helpful, a little bit more of a discussion. I know we are going to get into some of these issues even more in depth in the next panel, but it is important to have you here and we want to thank you for the service that you give to our country. Thank you very much.

Mr. DONAHUE. Thank you for inviting me.

Mr. KUCINICH. You bet.

We are going to go to the next panel.

Mr. ISSA. As the next panel is coming up, please give our best to our former colleague, Mr. Cox, when you see him.

Mr. DONAHUE. I certainly will.

Mr. KUCINICH. We are going to begin the second panel. I want to welcome all of the witnesses.

It is the policy of our subcommittee and the full committee to swear in all witnesses.

[Witnesses sworn.]

Mr. KUCINICH. Let the record show that the witnesses individually answered in the affirmative.

I would like to make the introduction of the first witness. We will go from my left to right.

Professor Mercer Bullard is assistant professor of law at the University of Mississippi School of Law, where he has been since 2002. He specializes in the areas of securities and banking regulation, corporate finance, and contracts, and he is recognized as one of the Nation's leading advocates for mutual fund shareholders.

In January 2000, Professor Bullard founded Fund Democracy, a nonprofit membership organization that serves as an advocate and information source for mutual fund shareholders and their advisors. Fund Democracy publishes articles that address mutual fund practices, policies and rules that may be harmful to fund shareholders, and by lobbying legislators and regulators on mutual fund reform issues.

Prior to founding Fund Democracy, Professor Bullard was Assistant Chief Counsel in the Securities and Exchange Commission's Division of Investment Management for 4 years, where he was re-

sponsible for a wide range of matters involving mutual funds and investment advisors.

Professor John Coffee is Adolph A. Berle professor of law at Columbia Law School, where he has been a member of the faculty since 1980. As one of the Nation's preeminent security and corporate law experts, Professor Coffee has served as a member of many influential financial advisory boards and commissions, including the New York Stock Exchange, NASDAQ, and the Securities and Exchange Commission. He has testified numerous times before congressional committees. He has co-authored a number of textbooks on securities and corporate law, and the National Law Journal has named him 1 of the 100 most influential lawyers in the United States.

Next, Mr. Joseph Borg is president of the North American Security Administrators Association, which represents 67 State, provincial, and territorial securities administrators. He has been a Director of the Alabama Securities Commission since 1994.

The NASAA member agencies work to protect consumers who purchase securities or investment advice, and regulate a wide variety of issuers and intermediaries who sell securities to the public.

Prior to his career in public service, Mr. Borg was in-house corporate counsel to First Alabama Bank, practiced in law firms in Montgomery, AL, and New York City. He also served as an adjunct professor of law at Faulkner University Jones School of Law.

Finally on the panel, Mr. Peter J. Tanous. Mr. Tanous is president and CEO of Lynx Investment Advisory, LLC, which he founded in 1992. Lynx Investment Advisory is an independent investment consulting firm specializing in asset allocation, risk management, and customized portfolio design. Lynx has over $1.4 billion under advisement, and on behalf of both nonprofit and for-profit institutions and affluent individuals worldwide.

Previously Mr. Tanous was executive vice president of Bank Audi in New York City, Chairman of Petra Capital Corp., and first vice president and international regional director with Smith Barney.

Mr. Tanous is the author of Investment Gurus: the Wealth Equation, and his latest book, Investment Visionaries.

I want to thank all the members of this panel for their presence, their participation.

Let us proceed with Professor Bullard.

I also want to welcome Mr. Danny Davis and also Mr. Bilbray to our committee. Thank you.

Let us proceed. Thank you. You may proceed.

STATEMENTS OF MERCER E. BULLARD, UNIVERSITY OF MISSISSIPPI LAW SCHOOL; JOHN C. COFFEE, JR., COLUMBIA LAW SCHOOL; JOSEPH P. BORG, PRESIDENT OF THE BOARD OF DIRECTORS OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; AND PETER J. TANOUS, PRESIDENT AND CEO, LYNX INVESTMENT ADVISORY, LLC

STATEMENT OF MERCER E. BULLARD

Mr. BULLARD. Chairman Kucinich, members of the subcommittee, thank you for the opportunity to appear today before you to discuss the public offering of interest and hedge fund managers. It

is an honor and a privilege to appear before this subcommittee today.

The question for today's hearing, Should investors be exposed to the risks of hedge funds, is answered by current law in the negative. Only sophisticated persons are permitted to invest in hedge funds. I believe that the answer should be the same for hedge fund managers that are the functional equivalent of hedge funds. There appears to be substantial agreement on this point. Virtually every commentator on the Blackstone IPO had described the firm's future prospects as depending directly on the performance of its funds. The financial press has suggested that the Blackstone offering, for example, provides a way for small investors to access the previously forbidden world of hedge funds.

It is worth noting that no one views the future prospects of pure asset managers such as T. Rowe Price as depending directly on the performance of their funds, and firms such as T. Rowe Price accordingly have traded at a tiny fraction of their assets under management, whereas hedge fund managers have traded at 20 or 30 times that fraction.

The markets recognize that hedge fund managers are the economic equivalent of hedge funds, and we should respect the market's judgment. The market's judgment is confirmed by the structure of hedge fund managers, as illustrated by Blackstone.

A majority of Blackstone's assets are investment securities. Of its $7.2 billion in assets on its March 31st balance sheet, $5.2 billion are investments in its funds and funds portfolio companies, another $4.1 billion are carried interest, which substantially exceeds 50 percent of its total assets. I note that includes a denominator that includes assets that have virtually nothing to do with any business activity, such as its goodwill, deferred tax assets, and cash. If you eliminate those assets, virtually all of the meaningful assets held by Blackstone are investment securities.

There is disagreement as to whether Blackstone's carried interest or investment securities under the Investment Company Act. I am not aware of any disagreement that carried interest are the economic equivalent of a leveraged bet on Blackstone's funds. Someone suggested that carried interest should be viewed as compensation. Professor Coffee, for example, suggests that carried interest are more like compensation on the ground that investors and hedge fund manager do not share the funds' "downside" because they will "simply not receive their share of the nonexistent profits from that fund."

I must respectfully disagree. Blackstone's $4.1 billion in carried interest are exactly what investors in Blackstone are buying, and that figure is based on the current value of those carried interests. If Blackstone's funds take a turn for the worse, Blackstone's investors will lose billions of dollars. The severity of those losses will actually exceed proportionately the decline in the funds because a carried interest skims profits off the top of a fund's performance. A slight decline in a fund's annualized performance has a multiplier effect on the value of a carried interest.

I would refer you to this morning's hearing on the Senate side, during which this point was made repeatedly by every one of the persons testifying at that hearing.

Professor Coffee's position is correct as to the Blackstone manager who sees a carried interest that started as a zero value and goes up and returns to zero, but it is incorrect as to the purchaser of a carried interest in the middle of a fund's life. When a Blackstone manager sells his carried interest at that point, he is effectively cashing out his part of the carried interest before its value has been realized and leaving public investors holding the bag in the event of the fund's performance declining.

Professor Coffee further suggests that reading the ICA to include carried interest in the definition of investment security reads the definition too broadly because it would mean that every business' "actively managed subsidiary would thus become an investment security. At this point, the ICA applies to everything."

That would be a fair observation but for the fact that the securities issued by subsidiaries would be investment securities under the Investment Company Act if Congress had not specifically excluded from the definition. The ICA defines investment security to exclude all securities, to include all securities except securities issued by majority-owned subsidiaries.

I mentioned Professor Coffee's comments not only out of my high regard for his opinions on securities law issues, but also because I believe that we are substantially in agreement on the critical policy question for this subcommittee. Although I have stated that public investors should not be allowed to assume the risk of hedge funds and Professor Coffee argues that they should, he uses risk in an economic sense and I use it in a broader functional sense. If risk were to include the risk of inadequate corporate governance, which I include in the concept of risk, Professor Coffee and many others would agree that public investors should not be exposed to such risk.

Professor Coffee describes Blackstone's corporate governance as pathological and recommends reforms notably that would apply if Blackstone were treated as an investment company under the Investment Company Act.

In conclusion, the ICA's regulatory framework and exemptive provisions are ideally suited to address the regulatory shortcomings that have been exposed by the Blackstone offering. It is unfortunate that the SEC has decided not to take advantage of this efficient, proven approach to regulation, and I strongly recommend that Congress, assuming continued SEC inaction, take steps to ensure the appropriate regulation of hedge fund managers.

Thank you very much.

[The prepared statement of Mr. Bullard follows:]

Testimony of Mercer E. Bullard

President and Founder
Fund Democracy, Inc.

and

Assistant Professor of Law
University of Mississippi School of Law

before the

Subcommittee on Domestic Policy

Committee on Oversight and Government Reform

United States House of Representatives

on

After Blackstone: Should Small Investors be
Exposed to Risks of Hedge Funds?

July 11, 2007

EXECUTIVE SUMMARY

When Congress enacted the Investment Company Act of 1940 ("ICA"), it generally divided the market of investment companies between those that could be sold publicly subject to regulation under the Act, and those that only could be sold privately without such regulation. Congress determined that investment companies, unlike other issuers, were particularly susceptible to abuse and that they therefore should be sold to unsophisticated investors only subject to pervasive, substantive regulation. The market has overwhelmingly endorsed this bifurcated regulatory structure, with assets of registered investment companies exceeding $11 trillion, and assets of private investment companies exceeding $1 trillion, at the end of 2006. The public offering of hedge fund managers threatens to derail the regulatory scheme applicable to investment companies.

Hedge fund managers are highly susceptible to precisely the abuses that Congress designed the ICA to address. They employ complex capital structures; invest in illiquid; difficult to value securities; use substantial leverage; concentrate their investments; engage in self-dealing transactions with affiliates; permit excessive compensation arrangements; and disenfranchise their shareholders. The SEC has stated that a major reason that it attempted to regulate hedge fund managers was the prevalence of fraud in the industry. Such concerns militate for caution when considering the sale of interests in hedge fund managers to small investors.

Hedge fund managers are functionally equivalent to the private investment companies they manage. The assets and income of hedge fund managers (as that term is used herein) are primarily attributable to direct holdings of shares in the funds they manage, co-investments in their funds' portfolio companies, and carried interests. Their economic performance is derived directly from the investment performance of the hedge funds they manage, a fact not lost on the markets. The financial press has universally linked their prospects to the future performance of their funds, and their market valuations equal about one-third of their assets under management, compared with one or two per cent for traditional asset managers. The financial press has recommended them to small investors as way to access the exclusive world of hedge funds. That is the appeal

of hedge fund managers because exposure to hedge fund returns is functionally what they offer.

Notwithstanding that hedge fund managers fall squarely within the definition of investment company under the ICA and raise precisely the investor protection concerns that the ICA is intended to address, the SEC has decided to leave their regulation to the "morals of the market place." It will be only a matter of time before a hedge fund manager experiences a dramatic collapse or perpetrates a colossal fraud. What will be different this time is that thousands of unsophisticated investors will incur substantial losses in an investment to which Congress has painstakingly attempted to restrict public access.

Congress should act promptly to ensure that hedge fund managers are not permitted to sell shares to unsophisticated investors without adequate regulation. This does not mean that hedge fund managers should be subject to all of the provisions of the ICA. Indeed, Congress granted the SEC broad exemptive authority to craft targeted exemptions from the ICA for the many issuers that fit the definition of investment company but are not appropriately regulated under the ICA. The SEC has adopted a number of rules and granted hundreds of exemptions pursuant to this authority, yet it has abdicated its responsibility to do the same for hedge fund managers. I strongly urge Congress, if the SEC declines to act promptly to ensure the proper regulation of hedge fund managers, to amend the ICA to expressly include hedge fund managers within its purview.

Chairman Kucinich, Ranking Member Davis, members of the Subcommittee, thank you for the opportunity to appear before you to discuss the public offering of interests in hedge fund managers. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law, where I teach securities regulation, law and economics, corporate finance, corporate law and banking law. I was previously an Assistant Chief Counsel in the SEC's Division of Investment Management and an attorney in the investment management practice of Wilmer, Cutler & Pickering (now WilmerHale). I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an informational Internet web site.

TABLE OF CONTENTS

I. INTRODUCTION

If the judgment of free markets were the only measure of regulatory efficacy, then mutual fund regulation would be an unqualified success. Americans have invested over $10 trillion in mutual funds, a testament to free market approval unmatched in the history of collective investment vehicles. The most striking aspect of mutual fund regulation is that it embraces the kind of merit regulation that Congress abjured elsewhere in the federal securities laws. The federal securities laws generally reflect Congress's view that the public offering of securities is best regulated through a system of disclosure that is designed to enable investors to make informed investment decisions. This approach reflects the view that the evaluation of the substantive merits of investments should be left to the markets. In contrast, mutual fund regulation reflects a decidedly merit-based approach to regulation. Mutual funds operate under both the full disclosure principles embodied in the Securities Act of 1933 and the detailed, pervasive operational rules codified in the Investment Company Act of 1940 ("ICA").

On the one hand, Congress adopted this approach to mutual fund regulation because of the heightened threat and complexity of the risks involved in the public offering of a highly liquid pool of securities. During 1920s and 1930s, the fund industry was rife with abuses that were exacerbated by weak corporate governance, complex capital structures, affiliated transactions, and leveraging. The ICA, which is the product of balanced negotiation between regulators and industry, prohibits or severely restricts the practices most prone to abuse.

On the other hand, Congress recognized that merit regulation itself created a kind of regulatory risk – the risk of regulatory obsolescence as market developments produce new financial instruments for which regulation under the ICA was inappropriate. Congress accordingly granted the SEC broad discretion to exempt firms that fell within the definition of investment company under the ICA from some or all of the ICA's provisions. For example, section 6(c) of the ICA of the authorizes the SEC to exempt issuers from the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the ICA]."[1] Congress also granted the SEC specific authority under section 3(b)(2) to exempt certain issuers that it found were not primarily engaged in the business of investing.[2] The SEC traditionally has exercised this authority to accommodate new financial instruments that trigger regulation under the ICA, but it has abandoned this proven approach to investment company regulation by allowing the public sale of hedge fund managers without appropriate regulatory oversight.

The public offering of hedge fund managers raises precisely the concerns that Congress intended the ICA to address. Hedge funds and hedge fund managers employ complex capital structures; invest in illiquid, difficult to value securities; use substantial leverage; concentrate their investments; engage in self-dealing transactions with affiliates; permit excessive compensation arrangements; and disenfranchise their shareholders. Congress decided that these practices were permissible for hedge funds provided that they were sold only to sophisticated investors. The public sale of hedge fund managers, which are the economic equivalent of hedge funds, directly contradicts Congress's intent and the express requirements of the ICA. Hedge fund managers fall squarely within the definition of the ICA, yet the SEC has decided leave their regulation to the markets instead of exercising its exemptive authority to tailor the provisions of the ICA to their particular needs. Congress should act promptly to ensure that hedge funds are appropriately regulated.

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[1] ICA § 6(c).

[2] *See* ICA § 3(b)(2).

This testimony discusses key aspects of mutual fund and hedge fund regulation in Parts II and III, respectively. Part IV analyzes the status of hedge fund managers under the ICA. This Part explains why hedge fund managers meet the definition of investment company under the ICA, with special attention paid to the general presumption that a general partnership interest is not a security and the nature of carried interests. Part V identifies some of the common practices of hedge fund managers that raise particular concerns under the ICA. Part VI briefly sets forth recommendations as to steps Congress should take to ensure the appropriate regulation of hedge fund managers. Part VII concludes.

II. MUTUAL FUND REGULATION

Mutual fund rules touch upon every aspect of their operations. The ICA effectively requires that funds be operated under the authority of a board of directors of which at least 40 per cent are independent of the fund's manager and its affiliates. The Act also assigns specific responsibilities to fund directors, including approval of the fund's contracts with its manager and principal underwriter. Exemptive rules have expanded the role of the fund board. The SEC has granted numerous exemptions from the Act relating to, among other activities, the pricing of fund shares, creation of multiple classes, charging of 12b-1 fees, and engaging in transactions with affiliates. Although these activities are prohibited by the ICA, the SEC decided that, subject to heightened board oversight and other conditions, exemptions that permit these activities could be granted consistent with the protection of investors. For example, funds that engage in activities in reliance on these rules generally must have a majority of independent directors and submit the nomination of independent directors to the board's independent directors.[3]

[3] As a consequence of the recent mutual fund market timing scandal, the SEC increased the independent majority to 75 per cent and required an independent chairman. *See generally* Mercer Bullard, *Comments on Martin Lybecker's Enhanced Corporate Governance*, 83 Wash. U. L. Q. 1095 (2005); Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 Houston L. Rev. 1271 ((2006). These requirements were vacated by a U.S. Court of Appeals and currently await re-proposal by the SEC. *See Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. 2006).

Mutual fund rules also grant specific powers to fund shareholders. For example, material changes in a fund's management contract or 12b-1 fees (*e.g.*, fee increases) require shareholder approval, as do changes in a fund's fundamental investment policies. The ICA authorizes private claims by fund shareholders against fund managers for charging excessive fees. The SEC has exempted hundreds of funds from shareholder approval requirements for management contracts when, for example, the fund uses a multimanager structure in which the fund's portfolio is managed by subadvisers.[4]

The ICA prohibits or restricts a wide range of transactions with affiliates. Many mutual fund lawyers consider these rules to comprise the heart of the statute.[5] Funds are generally prohibited from selling or buying securities or other property to or from their affiliates.[6] The ICA also includes a catch-all provision that prohibits "joint transactions" involving a fund and its affiliates except as approved by order of the SEC. The SEC has adopted numerous exemptive rules that permit transactions with affiliates, such as transactions between funds that are affiliated only by reason of their having a common manager. The SEC also has granted hundreds of exemptions from the joint transactions prohibition, including exemptions for business development companies -- which are functionally similar to private equity funds -- that permit co-investments in portfolio companies.

The ICA directly regulates funds' capital structure, investments and fees. For example, the Act severely restricts funds' ability to borrow or otherwise to create leverage, limits investments in financial firms and in other funds, and prohibits one-sided performance fees such as carried interests that do not provide for a reduction in fees in the event of underperformance. Leverage restrictions prevent the problems that caused Long-Term Capital Management's collapse in the late 1990s, which was partly due to its

[4] *See generally* Exemption from Shareholder Approval for Certain Subadvisory Contracts, Inv. Co. Act Rel. No. 26230 (Oct. 23, 2003) (discussing exemptions).

[5] *See* Remarks by Paul Roye before the Investment Company Institute 1999 General Membership Meeting, Washington, D.C. (May 21, 1999) (then Director, Division of Investment Management, SEC) (The importance of the prohibitions against affiliated transactions to mutual fund investors and to the mutual fund industry cannot be underestimated and the consequence of their demise cannot be overestimated.").

[6] For this purpose, the term "affiliate" is defined broadly to include persons and entities whose affiliation is one step removed from the fund. For example, a business in which a fund held a 10-per-cent interest would be an affiliate, as would an affiliate of that business (known as a "second-tier affiliate").

high debt-to-equity ratio.[7] Mutual funds are prohibited from issuing any senior class of securities, which generally prevents them from favoring some investors over others or otherwise permitting the creation of superior claims to fund assets other than those made by a general creditor.[8] Funds therefore cannot, for example, issue securities representing a severable interest in the performance of part of their portfolios or in the performance of their portfolios above a minimum rate of return. The SEC has granted numerous exemptions and provided extensive no-action guidance that provides conditional relief from restrictions on leverage and senior securities.

Mutual funds are required to effect transactions at their next calculated net asset value ("NAV") and generally must honor redemption requests in cash within seven days of tender. The practical effect of this requirement is that funds must value their portfolios based on current, verifiable market prices in order to ensure their ability to meet all redemption requests at NAV.[9] Toward this end, the SEC informally prohibits stock and bond mutual funds from investing more than 15 per cent of their portfolios in illiquid securities because of the uncertainties attendant upon their valuation. Funds generally are permitted to distribute capital gains only once each year in order to prevent confusion between income distributions and distributions that reflect a return or capital.

In summary, the ICA, in combination with SEC exemptive orders and rules, pervasively regulates fund operations. Without the regulatory flexibility provided by the SEC's exemptive authority, it is unlikely that the industry would have achieved its current level of success. Many of the structures used and features offered by mutual funds exist only because of the SEC's prudent use of its exemptive authority. For example, money market funds would not exist but for an SEC rule that permits the valuation of their shares at par. With over $2.3 trillion under management, money

[7] *See generally*, President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management at 10 - 22 (1999) ("*President's Working Group*"); Roger Lowenstein, When Genius Failed: The Rise and Fall of Long-Term Capital Management (2000).

[8] *See generally Implications of the Growth of Hedge Funds*, Staff Report of the Securities and Exchange Commission at 38 – 39 (2003).

[9] *See, e.g.*, In the Matter of Hammes, Inv. Co. Act Rel. No. 26290 (Dec. 11, 2003) (enforcement action involving mispricing of mutual fund's portfolio securities for which market prices were not readily available).

market funds have become the dominant short-term cash option for Americans.[10] Without SEC exemptive relief, funds would not be able to offer the multiple classes of shares that permit the tailoring of distributions arrangements to investors' particular needs. The use of fund assets for distribution, known as 12b-1 fees, also was prohibited until the SEC adopted rule 12b-1. Although subject to increasing criticism in recent years, rule 12b-1 has accounted for a substantial part of the growth of mutual fund assets. Along with multiclass funds and 12b-1 fees, SEC rules have permitted deferred sales charges, transactions between funds, and participation in affiliated underwritings that would otherwise have been prohibited or severely restricted under the ICA.

Of particular relevance here, the SEC has used its exemptive authority to permit public offerings by entities that trigger mutual fund regulation but for which the full application of the Act is not appropriate. In the fanfare surrounding the rapid growth of exchange-traded funds ("ETFs"), the SEC's central role in the creation of this popular new investment vehicle has been unfairly neglected. An ETF is an investment company that, for the most part, is regulated as a mutual fund. The ICA generally prohibits the offering of ETFs primarily because their shares are not individually redeemable, but the SEC granted exemptive relief from this and other ICA requirements because it recognized that ETFs could be sold without compromising the basic principles underlying the ICA. Exchange-traded funds operating under SEC exemptions held more than $420 billion in assets at the end of 2006.[11]

In other cases, the SEC has recognized that entities that are functionally similar to mutual funds should be granted more expansive relief from the ICA. The SEC has granted dozens of exemptions under section 3(b)2) of the ICA to entities that inadvertently fall within the definition of investment company under the ICA. Rule 3a-7, which is discussed further *supra*, generally excludes structured finance vehicles from the definition of investment company. Thus, the regulation of mutual funds has combined the benefits of a relatively fixed statutory regime and a flexible exemptive program to create the regulatory environment for one of the most successful financial services

[10] *See* ICI Fact Book at 127 (2007).

[11] *See id.* at 31.

products ever sold.[12] The success of mutual funds is a testament to the potential and importance of government action in wealth creation in a capitalist democracy.

III. HEDGE FUND REGULATION

Hedge fund regulation presents a stark contrast to the pervasive disclosure and substantive rules under which mutual funds operate. Hedge funds are not subject to regulation under the ICA, and hedge fund managers generally are not registered as investment advisers under the Investment Advisers Act of 1940 because they have a small number of clients.[13]

Hedge funds fall within the definition of investment company under the ICA, and they therefore are subject to regulation under that Act in the absence of an applicable exemption.[14] Hedge funds typically rely on one on the private offering exemptions under the ICA to avoid registration under the Act. These exemptions generally are available to funds whose outstanding securities are privately offered and: (1) beneficially owned by 100 or fewer investors, or (2) sold exclusively to qualified purchasers. Qualified purchasers include individuals with at least $5 million in assets. Thus, hedge funds are generally unregulated in the sense that they are subject only to antifraud rules under the

[12] *See* Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, SEC, at n.67 (May 1992) ("[T]he bill does not attempt to set up an ideal form of investment company and then compel all companies to conform to the ideal. Its provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions." (quoting Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 43 (1940) (statement of Robert E. Healy, Commissioner, SEC))).

[13] *See* Investment Advisers Act § 203(b)(3) (generally exempting investment advisers with fewer than 15 clients from registration). For this purpose, each fund counts as one client. The SEC adopted a rule that effectively required registration of hedge fund managers by defining "client" to include each investor in a fund, *see* Registration Under the Advisers Act for Certain Hedge Fund Advisers, Inv. Advisers Act Rel. No. 2333 (Dec. 2, 2004), but the rule was recently vacated by the U.S. Court of Appeals. *See Goldstein v. SEC*, 451 F.3d 873 (D.C. 2006) (vacating Investment Advisers Act rule 203(b)(3)-2).

[14] Hedge funds traditionally have relied on the private offering exemption to avoid registration under section 4(2) of the Securities Act of 1933 or Regulation D thereunder. A fund can be a registered investment company under the ICA without making a public offering for purposes of the Securities Act, although this is rarely done.

securities laws, securities regulations that apply generally to large institutional traders, and contract, corporate and other legal rules of general commercial applicability.

Like the enormous growth of mutual funds, the recent growth of the hedge fund industry is substantially attributable to the regulatory regime to which they are subject. Hedge funds' general freedom from regulatory investment constraints allows them to take risks and obtain returns that are impermissible and unavailable to mutual funds.[15] Their ability to charge one-sided performance fees provides stronger financial incentives to their managers to pursue superior risk-adjusted returns. Hedge funds are afforded the kind of governance and capital structure flexibility that permit a high level of responsiveness to a wide range of market opportunities. The combination of these factors presents a markedly different value proposition to investors from that which is presented by mutual funds. Although some research suggests that, in fact, hedge funds do not produce risk-adjusted returns superior to market returns,[16] the markets have provided an overwhelming endorsement of hedge funds and, implicitly, the general regulatory scheme under which they are regulated.

The occasional spectacular hedge fund collapse has not dimmed the market's enthusiasm for hedge funds. Limiting hedge fund investing to sophisticated investors presumptively mitigates the effect of hedge fund failures because hedge fund losses are easily absorbed by the diversified portfolios that sophisticated investors would hold. In theory, a properly diversified portfolio would hold enough outperforming investments to achieve superior risk-adjusted returns even after accounting for the occasional hedge fund implosion. Although one can argue that individual investors' eligibility to invest in hedge funds actually depends on their wealth rather than their sophistication, wealth is a useful, if imperfect proxy for sophistication. An individual's wealth also implies a greater capacity to absorb losses, and to the extent that wealthy investors have claims against their advisers for making unsuitable recommendations, they are more likely to bring these claims, and the claims are more likely to be cost-effective. In contrast, ineligible investors generally lack the sophistication to evaluate hedge fund risk, cannot

[15] *See generally Goldstein*, 451 F.3d at 875 - 76.

[16] *See, e.g.*, Burton Malkiel & Atuna Saha, *Hedge Funds: Risk and Return*, 61 Fin. Analysts J. 80 (2005).

easily absorb losses attendant upon the realization of such risks, and do not have the wherewithal or cost-effective claims to enforce their legal rights.

Thus, hedge fund regulation entails a kind of regulatory quid pro quo. Hedge fund managers and investors, and indirectly society at large, benefit from the potential for greater returns and more efficient allocation of capital that minimal regulation can facilitate.[17] In return, hedge funds may be sold only to sophisticated investors. This regulatory quid pro quo collapses, however, when retail investors are exposed to hedge fund risks, regardless of whether investors assume those risks by investing in a hedge fund or the hedge fund's manager.[18] When unsophisticated investors are permitted to invest in hedge funds or hedge fund managers, they are subject to precisely the risks that Congress enacted the ICA to address. For some investors, the risks will not be realized, and they may experience superior investment returns. It is inevitable that a publicly sold hedge fund manager will some day experience a sudden, dramatic collapse, however, and retail investors will experience substantial losses.[19] Unless Congress no longer supports basis for investment company regulation embodied by the ICA, it should take steps to ensure that this breach in regulatory scheme for mutual funds and hedge funds is promptly repaired.

IV. HEDGE FUND MANAGERS UNDER THE INVESTMENT COMPANY ACT

This section of this testimony explains why hedge fund managers are investment companies under the ICA, but before conducting that analysis, some preliminary points are necessary to frame the discussion. First, this testimony uses the term "hedge fund manager" to describe a manager the assets and income of which are primarily attributable to investments in securities issued by operating companies and investment companies,

[17] *See President's Working Group*, *supra* note 7, at 2.

[18] *See Goldstein*, 451 F.3d at 875 ("Investment vehicles that remain private and available only to highly sophisticated investors have historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds.").

[19] *See Hedge Funds: Risk and Return*, *supra* note 16, at 87 ("Investors in hedge funds take on a substantial risk of selecting a dismally performing fund or, worse, a failing one.").

and carried interests. Many hedge fund managers have very different sources of assets and income, but the managers of relevance to this testimony are those that have the characteristics of an investment company, such as the Blackstone Group ("Blackstone"). The term "hedge fund manager" also includes what are often referred to as "private equity managers" or "alternative asset managers." For purposes of investment company regulation, the various categories of managers of unregistered investment companies are not significant to the extent that the manager's assets and income are largely attributable to investments (including carried interests). This testimony uses Blackstone solely for illustrative purposes as a model of a hedge fund manager.

Second, it should be noted the most important policy question facing Congress is not so much the legal status of hedge fund managers, but rather their economic characteristics and the regulatory issues that these characteristics raise. As discussed below, an investment in a hedge fund manager is the functional equivalent of a leveraged investment in the manager's hedge funds. Such an investment therefore raises the same regulatory risks that are presented by hedge funds, and the federal securities laws prescribe that such investments should not be sold directly to retail investors. This does not mean, as often suggested by some commentators, that hedge funds are the exclusive province of the rich. In fact, the largest investors in hedge funds are institutional investors who invest assets that are beneficially owned by small investors. Prohibiting hedge funds and their managers from selling shares directly to small investors therefore does not deny these investors access to such investment opportunities, but merely requires that they make their investments through sophisticated intermediaries.

Third, it is entirely consistent with the definition of investment company and the overall structure of the ICA for a hedge fund manager to fit within that definition, despite the fact that in many respects it does not resemble a conventional investment company. The definition of investment company includes a wide range financial businesses that are different from conventional investment companies, yet they, too, fall squarely within the definition. The definition of investment company is so broad, for example, as to require express exclusions for banks; insurance companies; public utilities; investment banks;

consumer finance companies; common trust funds; certain oil, gas and mineral interests; public charities; and voting trusts.[20]

The definition of investment company even applies to operating companies that are not remotely similar to investment companies from an investment perspective, but that fit within the definition because they temporarily hold a substantial amount of investment securities. Congress accordingly created an exception for such companies to the extent that they are primarily engaged in a non-investment business and granted the SEC specific authority to exempt companies on the same basis.[21] Under this authority, the SEC promulgated rule 3a-1, which sets forth an assets and income test by which an investment company can escape from the statutory definition. The SEC also has routinely granted exemptive orders to such "inadvertent investment companies" provided that their situation is temporary and they hold only safe, liquid investments.[22] In some cases, the SEC may have exercised its exemptive authority too liberally, such as in the exemptions granted at the market's height in the late 1990s to firms such as Enron and Idealab!,[23] but at least the agency required that these firms submit to the process required by the ICA.

Thus, the ICA reflects Congress's adoption of a strategy of cutting a wide swath with the definition of investment company and then excluding entities through a combination of statutory and administrative exemptions. The SEC's decision to ignore the status of hedge fund managers as investment companies flatly contradicts both the express terms of the ICA and the inherent logic of its regulatory scheme. What is unusual about the Blackstone IPO is not the fact that it is an investment company, but rather the SEC's decision to allow Blackstone effectively to bypass this issue altogether. The SEC has a long history of respecting the breadth of the definition of investment company by

[20] *See* ICA §§ 3(a)(1)(C) & 3(c).

[21] *See* ICA §§ 3(b)(1) & (2).

[22] *See, e.g.*, *In the Matter of Applied Materials, Inc.*, Inv. Co. Act Rel. Nos. 27064 (Sep. 13, 2005) (notice) & 27114 (Oct. 12, 2005) (order).

[23] *See In the Matter of Bill Gross' Idealab!*, Inv. Co. Act Rel. Nos. 24469 (Mar. 28, 2000) (notice) & 24567 (July 26, 2000) (order); *In the Matter of Enron Corp.*, Inv. Co. Act Rel. Nos 22515 (Feb. 14, 1997) (notice) & 22560 (Mar. 13, 1997) (order).

conducting a substantive review of all entities that fit its terms. The SEC has variously: (1) forbidden the public offering of such firms without registration and full compliance with the ICA, (2) required registration under the ICA while exempting firms from certain of its provisions, or (3) granted firms a complete conditional or temporary exemption from the ICA. In contrast, the SEC's response to hedge fund managers has been to abdicate its traditional regulatory role to the market. Blackstone's operations as described in its registration statement implicate every one of the major concerns that were the impetus for the enactment of the ICA, and the nature of its assets and income reflect the essential characteristics of an investment company under the Act. The regulatory gauntlet having been thrown, the SEC has declined to meet the challenge that this new financial instrument has presented.

A. Why Hedge Fund Managers are Investment Companies

The ICA sets forth two definitions of investment company that apply to a hedge fund manager.[24] An issuer that satisfies either definition is an investment company, and Blackstone, for example, satisfies both. The first definition applies to an issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[25] Hedge fund managers hold themselves out as asset managers,[26] which leaves the inquiry under this definition as to whether -- notwithstanding how they hold themselves out -- they are primarily engaged in the business of investing in securities. The second definition applies to an issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a

[24] The third definition applies to an issuer that "is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding." ICA § 3(a)(1)(B).

[25] ICA § 3(a)(1)(A).

[26] *See, e.g.*, Blackstone Registration Statement at 60 (June 21, 2007) ("Blackstone Registration Statement") ("We believe that we are engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting or trading in securities. We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services.")

value exceeding 40 per cent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."[27] The second definition differs from the first in that merely holding securities is sufficient provided that the issuer meets the 40-per-cent test. Based on the information provided in its registration statement, Blackstone is primarily engaged in the business of investing and holding securities and more than 40 per cent of its total assets are investment securities.

i. The Primarily Engaged Definition

As illustrated by Blackstone, hedge fund managers fit the first definition of investment company. The nature of Blackstone's assets and income demonstrate that it is primarily engaged in the business of investing. Blackstone's registration statement provides no explanation as to why it does not fit within this definition except to state: "We do not believe the equity interests of The Blackstone Group L.P. in its wholly-owned subsidiaries or the general partner interests of these wholly-owned subsidiaries in the Blackstone Holdings partnerships are investment securities."[28] It appears from this statement that Blackstone relies on the general presumption under the federal securities laws that a general partnership is not a security (the "general partnership presumption") for its determination that it is not an investment company. It is correct that, if Blackstone does not invest in or hold any securities because its general partnership interests are not securities, it would not fall within either the first or second definition of investment company. Based on the information provided in Blackstone's registration statement, however, one could not reasonably conclude that Blackstone's use of a general partnership structure removes Blackstone from the definition of investment company.

[27] ICA § 3(a)(1)(C).

[28] Blackstone Registration Statement at 60.

1. General Partnership Interest

Blackstone carries out its operations through a multi-tiered structure. Blackstone owns a 100 per cent interest in a series of entities that act as general partners to a series of holding companies ("Blackstone Holdings") that directly or indirectly manage a series of hedge funds.[29] Through each of the general partnership interests, Blackstone owns 22 per cent of Blackstone Holdings.[30] The remaining 78 per cent of Blackstone Holdings is owned by Blackstone management. After its IPO, public investors owned 56 per cent of Blackstone, with the remaining 44 per cent owned by an investment company controlled by China ("China").

Although public investors and China own 100 per cent of the economic interests in Blackstone, they have no control over the firm. An entity controlled by Blackstone management acts as the sole general partner of Blackstone. The public investors have no ability to remove the general partner or otherwise exercise any effective control over Blackstone. The public investors' lack of any control over Blackstone means that they also have no control over the Blackstone's actions in its capacity of the general partner of Blackstone Holdings.

Blackstone's structure thereby illustrates one reason that the general partnership presumption does not apply. The presumption that a general partnership interest is not a security is based on the notion that traditional general partners "have the sort of influence which generally provides them with access to important information and protection against a dependence on others."[31] In Blackstone's case, however, the economic reality is that its public investors will have no influence, no access to information, and no protection against dependence on Blackstone management.[32] Although Blackstone itself

[29] A detailed diagram of Blackstone's structure appears at page 16 of its June 21, 2007 registration statement.

[30] This information is based on Blackstone's June 21, 2007 registration statement and does not reflect the sale of underwriters' overallotment of shares in the IPO. The sale of such shares would not change this analysis.

[31] *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir. 1981).

[32] *See Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 n.7 (4th Cir. 1988) (ultimate test of general partnership status is "the economic reality of partnership interests.")

effectively is the general partner of and exercises complete control over Blackstone Holdings, and Blackstone therefore has the requisite influence, access and protection of a general partner, those elements do not extend to Blackstone's public investors. The influence, access and protection afforded by the general partnership interest in Blackstone Holdings reside entirely with Blackstone management and do not extend to the public investors in Blackstone because they have no influence, access or protection *vis as vis* Blackstone, much less *vis a vis* Blackstone Holdings.

Blackstone's understanding of the general partnership presumption confuses the meaning of "security" in the context of the ICA with its meaning in other contexts. It is the SEC's longstanding position that a financial instrument that is not a security under other federal securities laws nonetheless may be a security under the ICA.[33] Under other federal securities laws, the term "security" serves the purpose of determining when what is being *sold* should be subject to the federal securities laws. Under the definition of investment company, the meaning of "security" determines whether what is being *held* by a firm should subject it to regulation under the ICA. Under the ICA, the question of what an entity invests in or holds is not asked out of a concern for the entity, but out of concern for the investors in the entity. The ICA is designed to regulate financial instruments the investing and holding of which raise the substantive concerns that the ICA is designed to address, *e.g.*, complex capital structures, leverage, affiliated transactions and excessive fees.

Blackstone's apparent position on the general partnership presumption would, in effect, render meaningless the definition of investment company. If the general partnership presumption applied to hedge fund managers, virtually any mutual fund could evade regulation under the ICA simply by holding interests in the fund through a general partnership interest. To illustrate, consider the Smith Large Cap Fund ("Smith Fund") that is managed by the Smith Management Company ("Smith"). As in a traditional mutual fund structure, public investors own shares of the Smith Fund that represent a *pro rata* interest in the net assets of the Fund. Smith could reorganize the fund as a

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[33] *See generally* Joseph Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, 7 Stan. J.L. Bus. & Fin. 1 (2002) (discussing SEC position on nonequivalence of meaning of security in ICA and other federal securities statutes).

partnership, the sole general partner of which would be Smith PTP, a publicly traded partnership. Smith would act as the sole general partner of Smith PTP. In a public offering, Smith PTP could offer 100 per cent of the economic interests in Smith PTP to public investors, with Smith retaining exclusive control over Smith PTP and thereby over the Fund. With the exception that Smith PTP's public investors would have no control over Smith PTP, the resulting structure would be functionally identical to the traditional mutual fund structure, but Smith PTP would not own any securities – assuming the general partnership presumption holds – and therefore would not be an investment company. The general partnership presumption is based on the investors' influence and access, yet the effect of interposing the general partnership interest in this illustration is to eliminate the investors' influence and access as to the fund. It is illogical to apply a general partnership presumption that derives from the nature of the investors' access and authority when the general partnership interest is used to eliminate investors' access and authority.

Congress anticipated the use of structures such as Blackstone's to evade regulation under the ICA. Section 48(a) of the Act prohibits any person from, "directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of [the ICA]." Accepting Blackstone's general partnership presumption would permit it to use an "other person" (the general partnership) to accomplish indirectly what Blackstone would be prohibited from doing directly. Thus, the mere interpositioning of a general partnership interest between a publicly traded partnership and a fund does not resolve the question of whether the publicly traded partnership is an investment company. Courts have consistently held that whether a financial instrument is a security depends on the particularly facts and circumstances. Whether the general partnership presumption holds for an entity such as Blackstone depends on the nature of the general partnership assets and income, in other words, on the application of the definition of investment company at the general partnership level. In the case of Blackstone, it is the assets and income of Blackstone Holdings that answer the question of whether the general partnership presumption holds.

2. Assets and Income

In the context of an entity such as Blackstone, the general partnership presumption is demonstrably rebutted by the nature of its assets and income. As of March 31, 2007, Blackstone held \$17.2 billion in assets, of which \$5.2 billion are categorized as "Investment, at Fair Value" and \$4.1 billion "Other Intangible Assets."[34] The category of Investment, at Fair Value includes investments in Blackstone's funds and co-investments in the funds' portfolio companies.[35] Blackstone "make[s] significant investments in the funds [it] manage[s]"[36] and expects to use some of its IPO proceeds to fund additional investments in its investment funds.[37] These investments and the investments in portfolio companies are clearly securities for purposes of the definition of investment company. The category of Other Intangible Assets substantially comprises carried interests.[38] Assuming that carried interests are also securities, as discussed *supra*, 54 per cent of Blackstone's assets are securities, and it therefore is primarily engaged in the business of investing.

This percentage is based on a generous calculation of the relevant denominator because it includes substantial assets that are not indicative any business activity other than investing. Blackstone's \$17.2 billion in assets includes a \$1 billion "Deferred Tax Asset," which reflects income tax benefits received by reason of the increase in the tax basis of assets purchased from Blackstone management to form Blackstone and it substantially offset by a \$863 million tax liability to Blackstone management.[39] The Deferred Tax Asset therefore does not reflect any business activity apart from the

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[34] Blackstone Registration Statement at 89.

[35] *Id.* at 181.

[36] *Id.* at 108.

[37] *See id.* at 181.

[38] The Other Intangible Assets "relate to the contractual right to future fee income from our management, advisory and incentive fee contracts and the contractual right to earn future carried interest from our corporate private equity, real estate and mezzanine funds." *Id.* at 91.

[39] *Id.* at 89 & 92 – 93 (*see* line item: "Due to Existing Owners"). The remainder of the \$1 billion is reflected as \$154 million adjustment to Partners' Capital. *Id.*

investing activities that are directly reflected by its $9.3 billion in securities. Blackstone's $3.7 billion in goodwill similarly does not reflect an alternative business activity to Blackstone's investing business. Blackstone calculated goodwill by subtracting the fair value of its tangible and intangible assets from the purchase price (that is, the price Blackstone paid to management to acquire interests in the various pre-IPO entities).[40] Thus, goodwill does not reflect assets that indicate any business other than investing. Blackstone's $1.8 billion in cash similarly indicates no business other than investing (and is expressly excluded from the asset denominator for purposes of the 40-per-cent test in the second definition of investment company). Thus, the 37 per cent of Blackstone's assets that are comprised of tax assets, goodwill and cash provide no evidence that Blackstone is engaged in any business other than investing. Removing these assets from the total assets denominator increases the percentage of its assets represented by investments (including carried interests) from 54 to 87 per cent, which further demonstrates that it is engaged almost exclusively in the business of investing.

Blackstone's income also reflects an enterprise that is primarily engaged in the investing business. In calendar year 2006, Blackstone's total income was $2.7 billion, of which $1.2 billion represented "Performance Fees and Allocations" and $385 million represented "Net Gains from Investment Activities."[41] Blackstone's "Net Gains from Investment Activities reflect the "realized and unrealized gains from underlying investments in corporate private equity, real estate and marketable alternative asset management funds."[42] Blackstone's "ability to generate carried interest is an important element of [its] business and carried interest has historically accounted for a very

[40] *Id.* at 90 – 91. Blackstone's "allocation [between intangible assets and goodwill] is subject to change as valuation analyses are finalized and remaining information on the fair value of assets and liabilities is received." *Id.* at 91.

[41] *Id.* at 95. In the first quarter of 2007, Blackstone received $1.3 billion in income, of which 68 per cent comprised the combination of $653 million in Performance Fees and Allocations and $228 million in Net Gains from Investment Activities. *Id.* at 96.

[42] *Id.* at 113. Specifically, a large percentage of its $385 million in 2006 Net Gains was "related to gains from [its] investment funds which are deconsolidated for segment purposes. The increase was primarily due to increases in appreciation in [its] real estate opportunity funds' limited service portfolios and recent office portfolio acquisitions." *Id.* at 118; *see also id.* at 95 & 116.

significant portion of [its] income."[43] Thus, 59 per cent -- a comfortable majority -- of Blackstone's income represents investing activities, which further demonstrates that it is primarily engaged in the investment business.

Blackstone's own characterization of its performance metrics reflects the view that it is primarily engaged in the business of investing. Blackstone's segment-by-segment financial information shows that it primarily evaluates its performance based on investment returns, not advisory fees. The financial information in Blackstone's segment-by-segment discussion:

> is reflected in the manner utilized by [its] senior management to make operating decisions, assess performance and allocate resources. Management makes operating decisions and assesses the performance of each of [its] business segments based on financial and operating metrics and data that are presented without the consolidation of any of the investment funds [it] manage[s].[44]

Blackstone's discussion of its corporate private equity segment, for example, shows that its income is primarily attributable to investment gains and carried interests. Of its "Economic Net Income" in calendar years 2004, 2005 and 2006 and the first quarter of 2007, 69, 72, 51 and 65 per cent, respectively, represents investment gains and carried interests.[45] Blackstone's Real Estate segment paints a similar picture, with 70, 69, 63 and 53 per cent of its "Economic Net Income" in calendar years 2004, 2005 and 2006 and the first quarter of 2007, respectively, being attributable to investment gains and carried interest.[46]

Not all of Blackstone's income reflects its investing business. In 2006, Blackstone received $854 million in Fund Management Fees and $257 million in Advisory Fees, which represents 41 per cent of its total income. The fact that Blackstone is also engaged in the asset management business, however, does not change the fact that

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[43] *Id.* at 180.

[44] *Id.* at 120.

[45] *Id.*

[46] *Id.* at 124. The Corporate Equity and Real Estate segments represent the largest segments of Blackstone's business, with 2006 Earned Net Income of $1 billion and $900 million, respectively. The next largest segments – Financial Advisory and Marketable Alternative Asset Management – had 2006 Earned Net Income of $194 million and $192 million, respectively. *Id.* at 128 & 131.

it is "primarily" engaged in the business of investing, as indicated by the predominance of investing reflected by its assets and income. If it charged primarily asset-based fees or reduced the amount of its direct investments in its funds and its funds' portfolio companies, a hedge fund manager such as Blackstone could easily escape the definition of investment company, but it has chosen to engage primarily in the business of investing and therefore falls within the first definition of investment company.

3. Carried Interests are Securities

The foregoing analysis assumes that carried interests qualify as securities and that income from carried interests should be treated as investment income. As discussed below, this assumption is supported by legal and practical considerations. For purposes of this analysis, a carried interest is a contractual right to receive a specified portion of the value of a security or portfolio that represents an annualized investment return in excess of a fixed minimum return, or "hurdle rate," after a specified period. This definition is intended solely for illustrative purposes, as the specific terms of a carried interest for any given fund varies widely, as illustrated by Blackstone's arrangements with the funds that it manages. Blackstone's carried interests generally entitle it to 20 per cent of its funds' net annual appreciation with hurdle rates of up to 10 per cent.[47] For example, a carried interest might entitle its holder to receive 20 per cent of a fund's return in excess of an annualized return of 10 per cent after 10 years ("20/10 carried interest"). If a portfolio was worth $386 million at its inception and had an annualized return of 10 per cent, it would be worth $1 billion at the end of ten years. After 10 years, the holder of a 20/10 carried interest would be entitled to 20 per cent of the value of the fund in excess of $1 billion. If the portfolio grew at an annualized rate of 20 per cent, it would be worth approximately $2.4 billion after ten years, and the carried interest owner would experience a gain of $280 million (20% * $1.4 billion).

A 20/10 carried interest shares the characteristics of a number of financial instruments that are included in the definition of security. For example, a carried interest

[47] *Id.* at 180.

is an "investment contract" as that term has been interpreted by the courts. A carried interest is an investment contract because its purchase constitutes an investment of money in a common enterprise with the reasonable expectation of profits solely from the efforts of others.[48] Public investors in a hedge fund manager: (1) pay money (2) that is pooled with money invested by others (3) for purpose of receiving a share of the profits of funds and portfolio companies (4) that depend solely on the efforts of Blackstone management and the management of the portfolio companies. As discussed above, the interpositioning of a general partnership interest cannot by itself change the fact that an investment in a hedge fund manager is functionally identical to an investment contract.

A carried interest also is functionally similar to an option, which is included in the definition of security. A carried interest is the functional equivalent of an option to purchase a security or pool of securities ("call option" or "call") at a strike price equal to the fund's value assuming that it performs at its hurdle rate. For example, a 20/10 carried interest would represent the right to receive 20 per cent of the difference between the value of a portfolio as the end of its ten-year life and its value assuming a 10 per cent annualized return. This is functionally identical to a call where the holder owns the right to purchase 20 per cent of a portfolio at a strike price equal to the portfolio's value assuming 10 per cent return ("20/10 call").

To illustrate, consider a fund with $386 million in assets at its inception, which would grow to $1 billion over its ten-year life assuming an annualized return of 10 per cent. If the fund's actual annualized return were 20 per cent, its value would be $2.4 billion after ten years. The holder of a 20/10 carried interest would receive 20 per cent of $1.4 billion at the of the 10-year period (*i.e.*, the difference between its ending balances assuming the 10-per-cent, hurdle-rate return and the actual 20-per-cent return), or $280 million. An investor who purchased an option exercisable after 10 years to buy 20 per cent of the fund for $200 million (the strike price) would experience an identical return as the 20/10 carried interest. At the end of 10 years, the 20/10 call would be exercised at the strike price of $200 million for a gain of $280 million ((20% * $2.4 billion) - $200 million). Thus, the gain on the carried interest and the stock option would be identical.

48 *See SEC v. Howey*, 328 U.S. 293 (1946).

A call and a carried interest are equivalent not only at the end of a fund's life, but also during the life of the fund. For example, if a 50 per cent owner of the fund held a 20/10 call, the other owner held a 20/10 carried interest, and each owner transferred all of his rights in the call/carried interest to separate public traded partnerships (PTPs) at the end of the fund's fifth year, the investors in each PTP would be identically situated. The unrealized value of each PTP would equal $68 million at the time the PTP was sold, after which the value of each PTP would fluctuate depending on the subsequent performance of the portfolio.[49] For example, if the fund's return were 10 per cent in each of its remaining five years (rather than the 20 per cent assumed above), its ending value would be $1.5 billion, and the liquidation value of each PTP would equal approximately $100 million (20% * ($1.5 billion – $1 billion)). The equivalence of carried interests and call options are illustrated by the manner that Blackstone has used to price carried interests. In its May 1 registration statement, Blackstone stated that it would "measure the fair value of its [carried interests], and their option-like payoffs, using a valuation model consistent with the Black-Scholes pricing framework . . . ."[50] Black-Scholes is a valuation tool used to price options that considers, among other things, the range of likely performance outcomes in measuring the present value of the financial instrument.

Some have argued that carried interests more closely resemble compensation for services, but carried interests bear strongly distinguishing characteristics. The traditional form of compensation paid for asset management services is an asset-based management fee, which differs from a carried interests in at least two significant respects. First, an asset-based fee rises and falls not only with the value of the managed portfolio, but also with assets under management. A 10 per cent decline in the value of a portfolio that is accompanied by a 10 per cent increase in assets under management will leave asset-based fee revenues unchanged. In contrast, a 10 per cent decline in the value of the portfolio will reduce the value of a 20/10 carried interest, while the increase in assets under management will have no effect. The carried interest on the new assets under

[49] For simplicity, this ignores future changes in the fair value of the call/carried interest. For accounting purposes, such changes would be included in calculating the fair value of calls and carried interests.

[50] Blackstone Registration Statement at 84 (May 1, 2007).

management have no value unless and until the portfolio's performance exceeds the hurdle rate.

Second, the 10 per cent decline in the fund's value causes a 10 per cent decline in the asset-based fee, whereas the effect of such a decline on the carried interest can range from zero to many multiples of the 10 per cent decline in the fund's value. It is in this sense that carried interests are leveraged financial instruments. To illustrate, consider a hedge fund with $1 billion in assets at its inception that pays its manager a 1 per cent asset-based fee and 20/10 carried interest.[51] If there were no change in the value of the fund after one year, but the fund received $100 million in new assets on its second day of operations, the manager's asset-based fee for that year would equal $11 million, with $1 million of that fee being attributable to the $100 million in new assets. The carried interest would be worth nothing, and the receipt of $100 million in new assets would have no effect on that value. Assuming that the same fund declines in value in its second year from $1.1 billion to $1 billion, the asset-based fee would decline from $11 million to $10 million, bringing total asset-based fees to $21 million. Again, the decline would have no effect on the still valueless carried interest.

Returning to the fund's first year and assuming no new contributions but a 10 per cent increase in value on the fund's first day to $1.1 billion, the asset-based fee in for the first year also would increase 10 per cent -- to $11 million. In contrast, the carried interest still would be worth nothing because the fund's annualized return would not have exceeded the 10 per cent hurdle rate. If the fund increased in value to $1.2 billion instead of $1.1 billion, the asset-based fee would increase by $1 million to $12 million. In contrast, the value of the carried interest for that year would increase from zero to $20 million (20 per cent of the $100 million increase in value above the hurdle rate value). Subsequent changes in the value of the fund would cause the amount of asset-based fees and the value of the carried interest to continue to diverge. A second-year increase in the fund's value from $1.2 to $1.5 billion would raise the asset-based fees for that year to $15 million, for a total of $27 million in fees over the first two years. The carried interest

[51] For simplicity, these illustrations assume that the carried interest is not valued using a pricing model that takes into account the likelihood that the fund's performance will exceed its hurdle rate. This assumption has no effect on relative leveraged nature of asset-based fees and carried interests. These illustrations also assume the calculation of fees and carried interests only at year-end.

would increase in value from $20 million to $60 million (20% * ($1.5 billion – $1.2 billion hurdle rate value)). While the total asset-based fees approximately double in value, the carried interest triples in value.

These illustrations show how dramatically changes in the value of the portfolio can affect the value of a carried interest compared to their effect on an asset-based fee. In comparison with asset-based fees, which are earned on an ongoing basis and stable relative to the value of the portfolio, carried interests are highly unstable. This key difference between asset-based fees and carried interests – between compensation for services and a leveraged equity investment -- is most starkly illustrated when a portfolio declines precipitously in value. If the fund discussed immediately above declined in value on the first day of its third year from $1.5 billion to $1 billion, the manager would add another $10 million to its asset-based fees while retaining previous fees, thereby bringing total asset-based fees for the three-year period to $37 million. In contrast, the value of the carried interest would decline from $60 million to zero *in one day*. The loss of the entire value of the carried interest illustrates how it is fundamentally different from compensation for services. Unlike carried interests, compensation for services cannot have negative performance.

When public investors purchase units representing carried interests, they are purchasing a leveraged equity financial instrument. At the end of the fund's second year in the foregoing example, the value of the carried interests would equal $60 million plus the expected value of future changes in that amount due to the fund's future performance. A simplified estimate of the value of future increases, assuming that the fund would increase in value during the third year at the same rate as in each of the first two years (22.5 per cent annually), would produce an expected liquidation value of $100 million at the end of the third year.[52] If the investors paid $100 million for the carried interests at the end of the second year, they would incur a $100 million, 100 per cent loss when the fund was liquidated at the end of the third year. In contrast, the purchaser of the right to the manager's asset-based fees for all three years would lose a small fraction of this

[52] Assuming that the hedge fund had a three-year life and third-year performance would equal to the annualized return of the fund to date, the expected value of the carried interest at the end of the second year would be $100 million. This equals the $60 million value of the carried interest at the end of the second year plus the $40 million increase attributable to the fund's third-year, 22.5 per cent return.

amount.[53] The "clawback" to which carried interests are subject is simply a different name for leveraged investment losses and cannot reasonably be characterized as an aspect of compensation for services.

ii. The 40-Per-Cent-Test Definition

The second definition of investment company applies to any issuer that is engaged in the business of investing or holding securities and owns investment securities the value of which exceeds 40 per cent of the value of its total assets, exclusive of government securities and cash. If a hedge fund manager is *primarily* engaged in the business of investing, as demonstrated in the immediately preceding discussion, then it necessarily is engaged in the business of investing under the first part of the second definition. The absence of the term "primarily" in the second definition means that the business of investing need not be the issuer's predominant activity. This implies that an asset manager would be an investment company even if its assets and income were substantially less than 50 per cent attributable to its investing business. A hedge fund manager also is an investment company if only engaged in the business of merely *holding* securities as opposed to actively investing. This means that the sale of a package of carried interests tied to a fixed portfolio with a finite life would not disqualify an issuer by reason of its passive, fixed nature.

The first part of the second definition reflects Congress's intent to bring initially within the definition of investment company even those issuers that only inadvertently acquire the characteristics of an investment company while engaging primarily in some

[53] Under one set of assumptions, the purchaser of three year's of asset-based fees at the end of the second year would lose \$3.7 million on a \$44.7 million investment (an 8.3-per-cent loss), calculated as follows. Based on the assumption that the third year's expected 22.5 per cent return would increase its value to \$1.8 billion, the purchaser would have expected an \$18 million payment for that year. Based on a 10 per cent discount rate, this end-of-year payment could be purchased for approximately \$16.5 million. The first two years of fees could be purchased for an additional \$28.1 million, assuming that the first year's \$12 million payment earned 10 per cent during the second year (\$13.2 + \$15 = \$28.2). The total purchase price would be \$44.7 million (\$28.2 + \$16.5). At the end of the third year, the \$28.2 in prior fees would be worth \$31 million, but the \$16.5 million paid for the third year's fee would be worth only \$10 million (1% * \$1 billion), which produces a final value of \$41 million, or a \$3.7 million loss on the \$44.7 million investment. This represents an 8.3 per cent loss, in comparison with the 100 per cent loss on the purchase of the carried interest.

other activity. The inadvertent nature of the second definition is further evidenced by its requirement that more than 40 per cent of an issuer's total assets represent investment securities.[54] An operating company may have good reason to hold substantial assets in the form of investment securities, such as when it sells a substantial subsidiary and invests the proceeds in investment securities pending their use in a planned acquisition.[55] Congress did not intend that these firms be regulated under the ICA, but it chose to err on the side of caution by including them in the second definition of investment company and then excluding them from that definition either through the application of section 3(b)(1) of the Act, which excludes any issuer that is primarily engaged in a non-investment business, or a finding by the SEC under section 3(b)(2) of the Act that the issuer is primarily engaged in a non-investment business. The SEC has granted dozens of exemptions under this provision, and issued two rules that set forth broad-based, objective tests under which an issuer is excluded from the definition of investment company.[56]

As discussed above, a hedge fund manager is primarily engaged in the business of investing, which, coupled with the fact that more than 40 per cent of its assets are investment securities, establishes that it is an investment company under the second definition. For example, when Blackstone's cash assets are excluded, the value of its investment securities equals 60 per cent of its total assets, far in excess of the 40 per cent maximum allowed under section 3(a)(1)(B). Blackstone does not qualify for the section 3(b)(1) exclusion because it is not primarily engaged in a non-investing business, and it fails the tests provided under SEC rules.[57]

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[54] The ICA also defines "investment securities" to include all securities except: "(A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c)." ICA§ 3(a)(2).

[55] *See SEC v. Nat'l Presto Indus.*, 486 F.3d 305 (2007).

[56] *See* ICA rules 3a-1 and 3a-2.

[57] Rule 3a-1 excludes issuers from the second definition of investment company if no more than 45 per cent of their net income over the preceding 4 quarters and no more than 45 per cent of their total assets (excluding cash) are generally attributable to securities. While Fortress Investment Group, a hedge fund manager whose IPO preceded Blackstone's, claims to qualify under this rule, Blackstone does not. *See* Fortress Investment Group Registration Statement at 48 (Feb. 8, 2007).

In summary, hedge fund managers whose assets and income are primarily attributable to investments in securities, including carried interests, fall squarely within two definitions of investment company under the ICA. Hedge fund managers trigger the first definition because they are primarily engaged in the business of investing in securities, as evidenced by the fact that a majority of their assets are securities and a majority of their income is derived from investment gains and investment income. They trigger the second definition because they are primarily engaged in the business of investing in securities and more than 40 per cent of their assets are investment securities. The conclusion that hedge fund managers are investment companies is reinforced by the policy concerns raised by the public offering of hedge fund managers. The structure and operation of hedge fund managers – regardless of whether they fall within the definition of investment company – raise precisely the risks that Congress designed the ICA to address and tasked the SEC to oversee, as discussed in the following section of this testimony.

V. HEDGE FUND MANAGERS AND INVESTOR PROTECTION UNDER THE INVESTMENT COMPANY ACT

Hedge fund managers' structure and operations provide a virtual roadmap of the kinds of potentially abusive activities that the ICA is designed to severely restrict or prohibit. Congress intended that the ICA address to a number of potential abuses that are particular to liquid pools of securities. The ICA prohibits or severely restricts, among other things, extreme leverage, differential treatment of shareholders, complex corporate structures, side deals between fund managers and the companies in the funds they control, fee increases that have not been approved by shareholders, one-sided performance fees, and valuations based on other than the market prices of the fund's portfolio securities. There is nothing necessarily harmful about any of these practices, and the federal securities laws permit private investment companies to engage in some or all of them. The ICA stands for the proposition, however, that such practices should be strictly regulated when the investment company is sold to unsophisticated investors

unless the SEC has made an express determination that exemptive relief from some or all of the provisions of the ICA is appropriate. Some of the practices that the ICA is designed to regulate and their use by hedge fund manager are addressed below.

Many of the abuses that prompted the enactment of the ICA were attributable to the complex capital structures used by fund managers to divert the economic benefits of ownership from investors to managers and their affiliates. The ICA generally prohibits mutual funds from offering different classes of shares with different voting rights or different rights to dividends, capital gains and other economic incidents of ownership. In contrast, hedge fund managers use capital structures that grant or can be used to grant special rights and privileges to favored shareholders. For example, the Blackstone offering separated the firm into three different components. Blackstone management retained control over the general partner and effective control over all other decisions by reason of its ownership of 86 per cent of the voting units in Blackstone Holdings. The public investors have no voting rights as to the identity of the general partner, and their rights as to the limited matters on which they are entitled to vote represent a 14 per cent interest. The units sold to China have no voting rights on any matter but were purchased at a 5 per cent discount to the public offering price.

Hedge fund manager structures also can be used to subvert the regulation of investment company fees. Mutual funds generally cannot increase their fees without the approval of the funds' independent directors and shareholders. A hedge fund manager is controlled by management, which has exclusive authority to increase its own compensation without shareholders' consent. For example, Blackstone does not have a compensation committee or intend to create one; rather, it plans to continue to vest complete discretion over compensation matters to its two founders.[58] Blackstone concedes that employee compensation "will increase prospectively"[59] and public

[58] Blackstone Registration Statement at 196; *see also id.* at 202 (describing delegation of authority over Equity Incentive Plan to two top executives). Cash distributions to Blackstone's top five executives in 2006 were $398.3 million, $212.9 million, $97.3 million, $45.6 million and $17.4 million. *Id.* at 197 – 98. Although mutual fund directors have no direct say in the compensation paid to the fund manager's executives, such compensation is derived indirectly from the fees paid to the manager and approved by the fund's board.

[59] *Id.* at 108.

investors will have no say in such increases. Needless to say, Blackstone's investors' ability to control management fees will fall far short of the ICA's requirement that any fee increases be expressly approved by shareholders.

In fact, Blackstone's carried interests represent the kind of incentive compensation that the ICA strictly prohibits. Congress believed that incentive compensation that rewarded a fund manager for superior performance but did not punish the manager for inferior performance would create excessive incentives to take risks. The ICA therefore permits mutual fund managers to charge an incentive fee only if the increase in the fee due to good performance is matched by a decrease in the fee for poor performance. Hedge fund managers such as Blackstone collect carried interests, which may create an incentive to take greater risks without the disciplining effect of reduced fees resulting from underperformance.

The heart of the ICA is its provisions that restrict or prohibit transactions between funds and their affiliates. One of principal abuses that occurred prior to the enactment of the ICA was the use of funds by their managers to effect transactions that were disadvantageous to the fund. Hedge fund managers engage in such potentially abusive transactions as a matter of standard practice.[60] For example, Blackstone receives "monitoring" and "disposition" fees from portfolio companies[61] that would be impermissible for a mutual fund manager. Although Blackstone's investors, unlike direct investors in its hedge funds, stand to benefit to the extent that the fees are paid to Blackstone, these fees nonetheless present the potential for abusive side-deals when paid to Blackstone but diverted to Blackstone managers as compensation or paid directly to Blackstone management through affiliated entities they control.

Blackstone managers also co-invest in portfolio companies in which Blackstone owns direct stakes or indirect stakes through carried interests.[62] Such co-investments

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[60] *See, e.g.*, John Hechinger, *Hedge Funds' Gift Grabs*, Wall St. J. at C3 (June 28, 2007) (describing Massachusetts complaint filed against broker-dealer for "improperly providing below-market office space, low-interest personal loans and other perks to Boston-based hedge-fund executives if they steered enough business to [the broker-dealer]").

[61] Blackstone Registration Statement at 180. Blackstone also receives transaction fees on fund acquisitions, *id.*, that may be paid by the portfolio companies.

[62] *Id.* at 181.

invite abuse because they create a potential conflict of interest between management and other investors in the portfolio companies, including public investors in Blackstone itself. For example, co-investments may be made on terms that are more favorable to Blackstone management or Blackstone affiliates than to Blackstone. These transactions can benefit investors and are permitted to hedge funds, but only because the law presumes that sophisticated investors can fend for themselves. The SEC has granted numerous exemptions subject to strict conditions to permit co-investments by investment company affiliates, but Blackstone managers' will not be subject to such oversight.

The ICA substantially restricts risk-taking by mutual funds by limiting the amount of leverage they are permitted to employ. The ICA limits borrowing and prohibits the issuance of senior securities, which the SEC has interpreted to restrict funds' ability to invest in derivatives that are effectively leveraged. No such restrictions apply to hedge funds. For example, Blackstone reserves broad discretion to use leverage to increase returns, thereby increasing the risk of loss that the ICA was designed to limit. As discussed above, carried interests create leverage with respect to market performance that is the functional equivalent of a call option. Long-Term Capital Management's leverage-to-equity ratio exceeded 25:1, which contributed substantially to its downfall.[63] To the extent that a hedge fund manager holds assets in the form of investments in its hedge funds, leveraged investments in its hedge funds' portfolio companies, or carried interests, its owners will be exposed to risks that Congress prohibited for public investment companies.

The ICA requires that funds value their assets at their market value and, for assets for which there is no readily available market price, at the fair value that could be realized on their present sale. Illiquid securities are particularly difficult to value because their price can change dramatically in response to market conditions. When a hedge fund encounters difficulties, it often must sell securities quickly to meet the terms of loans or redemption demands which may push the value of the securities below their market value. Pricing risk is further exacerbated for hedge funds that use leverage because

[63] *See President's Working Group*, *supra* note 7, at 12.

leverage has the effect of multiplying small pricing errors.[64] These factors played a significant role in the collapse of the junk bond market in the 1980s and Long-Term Capital Management in the 1990s, and the problems recently encountered by two Bear Stearns hedge funds.[65] Hedge fund managers hold precisely the kind of illiquid securities that are difficult to value.[66]

The basis on which Blackstone values its portfolios illustrates the uncertainty of pricing illiquid securities. Blackstone's portfolio companies do not trade in a secondary market, which leaves only fundamentals and valuations of comparable firms as sources of pricing information.[67] Its valuation approach thereby raises precisely the risks that the

[64] *See id.* at 5 ("compared with other trading institutions, hedge funds' use of leverage, combined with any structured or illiquid positions whose full value cannot be realized in a quick sale, can potentially make them somewhat fragile institutions that are vulnerable to liquidity shocks."); *see also* Justin Lahart & Aaron Lucchetti, *Wall Street Fears Bear Stearns is Tip of an Iceberg*, Wall Street Journal at A1 (June 26, 2007) (*Wall Street Fears*) ("Such securities trade infrequently, which makes it hard to sell them quickly without incurring steep losses. The funds, especially the Enhanced Leverage Fund, used borrowed money, or leverage, to amplify returns. But leverage also amplifies losses when a fund's bets go sour. . . . Still, the increase in illiquid investments raises concerns. For one thing, even in liquid securities like stocks, what can seem like a ready supply of cash can dry up quickly if investors get spooked. Those problems are heightened when leverage is used.").

[65] *See Wall Street Fears, supra* (also noting huge losses sustained by Askin Capital Management in 1994 "on leveraged bets on infrequently traded mortgage-backed securities," $6 billion in losses sustained by Amaranth in 2006 "when it couldn't easily exit esoteric trades that went against it," and $560 million in losses sustained by Bank of Montreal "earlier this year . . . with bad bet on natural-gas volatility.").

[66] *See generally id.* ("Unlike stocks or bonds listed on an exchange, such assets can't be readily bought or sold. That makes it hard to establish an accurate price for them. Fund managers have broad discretion in attaching a value to these assets, and often don't reveal many details of their trades. . . . One reason the Bear Stearns funds' troubles worry Wall Street is the fear that other players own similar securities that have similarly been mispriced. If the funds' holdings were auctioned off, as their lenders had threatened to do, there would be a market to mark to -- albeit one that, because of the fire-sale quality of the auction, would value such securities well below what they otherwise might be worth."). The SEC recently reached a settlement with Allied Capital Corporation that illustrates the pitfalls of pricing securities that are difficult to value. *See* In the Matter of Allied Capital Corp., Admin. Proc. File No. 3-12661 (June 20, 2007) (sanctioning business development company for violating pricing rules, which involved, e.g., marking down securities from $20 million to $245,000, $16.5 million to $50,000, and $8 million to $50,000).

[67] Blackstone describes its methodology for valuing net investment gains as follows:

> "Net gains (losses) from our investment activities reflect a combination of internal and external factors. . . . The key external measures that we monitor for purposes of deriving net gains from our investing activities include: price/earnings ratios and earnings before interest, taxes, depreciation and amortization ("EBITDA") multiples for benchmark public companies and comparable transactions and capitalization rates ("cap rates") for real estate property investments. In addition, third-party hedge fund managers provide information regarding the valuation of hedge fund investments. These measures generally represent the relative value at which comparable entities have either been sold or at which

ICA is designed to minimize. The ICA requires that the pricing of illiquid securities be overseen by the funds' directors, a majority of whom generally must be independent of the fund manager, whereas Blackstone management has complete discretion in the pricing of its securities.[68] While there is no reason to believe that Blackstone is manipulating its portfolio valuations, the history of hedge funds is rife with incidences of fraudulent pricing,[69] and the law of averages dictates that there will be publicly offered hedge fund managers who will do the same.[70]

In summary, publicly held hedge fund managers present precisely the risks attendant upon investments in collective investment vehicles that Congress intended to regulate through the ICA. Hedge fund managers are investment companies that fall squarely within the definition of investment company, but even if they do not, they create the same risks that the ICA is designed to address. This is not to say that hedge fund managers should be subject to all of the provisions of the ICA, but rather that it is the SEC's responsibility to ensure that publicly offered hedge funds are subject to appropriate regulation. The SEC's decision to allow the Blackstone offering to proceed without obtaining an exemption from the ICA reflects a short-sighted perspective that will leave future Commissioners to explain why, when a publicly held hedge fund

> they trade in the public marketplace. . . . Internal factors that are managed and monitored include a variety of cash flow and operating performance measures, most commonly EBITDA and net operating income."

Blackstone Registration Statement at 113; *see also id.* at 138 - 140.

[68] *Id.* at 138 – 39 ("For some investments little market activity may exist; management's determination of fair value is then based on the best information available in the circumstances, and may incorporate management's own assumptions and involves some degree of judgment . . .. ") & 141 ("The determination of investment fair values involves management's judgments and estimates. The degree of judgment involved is dependent upon the availability of quoted market prices or observable market parameters."). On a pre-IPO, consolidated basis, 91 per cent of Blackstone's funds' assets "represent assets for which market prices were not readily observable." *Id.* at 140; *see also id.* at 141 (table showing Level III valuations where "[p]ricing inputs are unobservable for the investment and includes situations where there is little, if any, market activity for the investment.").

[69] *See Implications of Growth of Hedge Funds*, *supra* note 8, at n. 257 (citing cases).

[70] Mutual funds have not been immune to portfolio mispricing. *See generally* Mercer Bullard, *Dura*, Loss Causation, and Mutual Funds: A Requiem for Private Claims? __ Cincinnati L. Rev. __ (forthcoming 2007).

manager inevitably collapses, it was appropriate not to apply any of the regulatory constraints to such entities that apply to their functional siblings – mutual funds.

The history of hedge funds dictates that such a collapse will occur, and as long as investors in these investment vehicles are limited to sophisticated purchasers, their periodic failure can be viewed as reflecting the efficient operation of a high risk market of which colossal failures are a necessary characteristic. The recent travails of two Bear Stearns hedge funds illustrate this risk. If Bear Stearns' only business had been managing those hedge funds, its investors would have experienced even greater losses than the investors in the funds if the firm held substantial carried interests. When a hedge fund collapses and its manager is devoted primarily to managing that fund, the combination of the manager's interests in the fund or its portfolio companies and its carried interests makes it likely that the manager will incur even greater losses than its funds. A manager such as Blackstone may manage a sufficiently diverse set of funds so as to weather the collapse of one or two of them, but less diversified managers will not. The SEC will not be able to treat differently hedge fund managers that are highly leveraged or concentrated because their status under the ICA cannot depend on either factor. By allowing an entity such as Blackstone to make a public offering with an exemption, the SEC has issued a free pass to all hedge fund managers.[71] When a publicly held hedge fund managers fails, the losses will not be limited to sophisticated investors, but will be shared by the same unsophisticated investors whom Congress intended to protect from such risks.

VI. RECOMMENDATIONS: EXEMPTIVE REGULATION OF HEDGE FUND MANAGERS UNDER THE INVESTMENT COMPANY ACT

When a hedge fund manager's assets and income are primarily attributable to carried interests and investments in their funds and their funds' portfolio companies, investors in the hedge fund manager own the functional equivalent of a leveraged

[71] The SEC has not explained its analysis, but it may take the position that a hedge fund manager would trigger the second definition of investment company if units in its funds plus co-investments in fund portfolio companies (and other investment securities) represented more than 40 per cent of the value of its total assets excluding government securities and cash. On this basis, Blackstone's securities represent only 34 per cent of its assets.

investment in the managers' funds. There does not appear to be any serious disagreement on this point, with those objecting to regulation under the ICA basing their arguments solely on technical grounds such as the interpositioning of the general partnership interest and the legalistic characterization of carried interests as compensation for services. As discussed above, these legal arguments fail under close scrutiny, but the more important issue for Congress is the SEC's decision that firms that are the economic equivalent of investment companies should not be subject to any of the investor protection measures that Congress created for such entities. If the SEC continues to decline to fulfill its statutory responsibility to craft an appropriate regulatory scheme for publicly held hedge fund managers, Congress should act promptly to cause it do so.

Two general courses of action are available to ensure that public sold hedge fund managers are appropriately regulated. The first would be to cause the SEC to treat hedge fund managers as investment companies, in which case the SEC would have to grant exemptive relief or regulate hedge fund managers under the ICA. The second course of action would be to amend the ICA to apply selected provisions to hedge fund managers that implicate the concerns that the ICA is intended to address. These options are briefly discussed below.

B. Regulation by Administrative Exemption

As discussed above, Congressional action would be unnecessary if the SEC applied its exemptive authority and substantial expertise in this area to construct an appropriate regulatory regime for hedge fund managers. Although the SEC has declined to accept this responsibility, a number of approaches are available to Congress to cause the SEC to reverse course. One approach would be to require that the SEC provide a full explication of its treatment of carried interests under the ICA, including an analysis of whether carried interests could be sold through a structure finance vehicle without registration under the ICA. This request might cause the agency to recognize that carried interests must be treated as securities in some circumstances and to recognize that certain hedge fund managers therefore are investment companies under the ICA.

If the SEC is inflexibly committed to the position that carried interests can never be considered securities, then Congress could amend the definition of securities for purposes of the definition of investment company to include carried interests. It should be emphasized that the effect of such an amendment would not be to subject hedge funds to the full force of the ICA. Rather, this approach would merely require that hedge fund managers obtain exemptive relief from the ICA as appropriate.

One disadvantage of this approach is that hedge fund managers may simply restructure their compensation so as to fall outside the definition of carried interest, in which case Congressional action again would be needed if the SEC continued to be unwilling to act. Another disadvantage is that the SEC already seems inclined to grant hedge fund managers a complete pass from ICA regulation, and it therefore may grant exemptive relief to hedge fund managers on overly generous terms. This role is one that Congress expressly delegated to the SEC, however, and it should assume that the SEC will exercise its authority consistent with Congress's intent until proven otherwise.

C. Regulation by Statutory Exemption

Congress's second option is to amend the ICA to create a new form of investment company that would be subject to only certain provisions of the Act. This approach, although less flexible and more drastic and administratively burdensome, would not be unprecedented. The ICA itself uses this approach in subjecting unit investment trusts, closed-end funds and business development companies to less regulation than to mutual funds.

The regulation of business development companies under the ICA is particularly instructive as to how Congress (and the SEC) might approach the regulation of hedge fund managers. Business development companies are, in effect, publicly sold private equity funds that operate pursuant to only a limited number of provisions under the ICA.[72] Like BDC regulation, the regulation of hedge fund managers should retain the ICA's core affiliated transaction prohibitions. Affiliated transactions present the greatest potential for self-dealing by management and often are not susceptible to easily

[72] *See* ICA §§ 54 – 65.

understood disclosure. The definition of an affiliated person, however, would have to be modified to accommodate some of the affiliations with portfolio companies that are common for hedge fund managers.

The most difficult accommodation probably would arise in connection with corporate governance, capital structure and fee regulation under the ICA. While exchange listing standards may provide an adequate substitute for independent oversight by an ICA-compliant board, they do not provide comparable protection against management exploitation of the separation of economic and voting interests. It is notable that the separation of economic interests and voting control is prohibited by the major exchanges, but not if the separation occurs prior to a firm's IPO. In the hedge fund manager context, there should be restrictions on management's control over major decisions, including especially decisions that entail a conflict of interest between management and shareholders. Such conflicts would include most obviously decisions regarding management compensation. In addition, although shareholder approval of all increases in executive compensation might be unworkable, such compensation should be subject to standardized disclosure comparable to that provided under the ICA. This would entail fee tables for both the compensation arrangements with respect to managed funds and executive compensation paid by the hedge fund manager to its executives.

Much of the remainder of the ICA's provisions could be addressed through prominent, targeted disclosure. Although some absolute limits on leverage may be appropriate, the risks presented by leverage could be substantially mitigated by standardized, quantitative disclosure. Such disclosure could show potential losses under relevant scenarios, such as the effect of rising interest rates or falling housing prices on a portfolio of subprime loans. Hedge fund managers that oversee a sufficiently diversified set of collective investment pools (or pools that are themselves registered under the ICA) might be entirely exempt from leverage restrictions, although the diversification test applied under the ICA would not be adequate for this purpose. Disclosure similarly could address the presentation of investment performance, such as by requiring the periodic disclosure of standardized investment returns net of fees.

As a general matter, however, the optimal approach to tailoring the requirements of the ICA to fit hedge fund managers should begin with hedge fund managers' views

regarding the aspects of the ICA that are inconsistent with their business models and the reasons that these provisions can be waived or modified consistent with the protection of investors. Hedge fund managers are in the best position to determine whether and to what extent their operations necessitate exemptive relief from the ICA. Just as the ICA itself was the product of a joint effort by regulators and industry,[73] the regulation of hedge fund managers should reflect the realities of industry as understood by the industry, as well as the necessity of effective investor protection.

VII. CONCLUSION

Hedge fund managers fit the definition of investment under the ICA and raise precisely the investment protection concerns that Congress intended the ICA was intended to address. They employ complex capital structures; invest in illiquid; difficult to value securities; use substantial leverage; concentrate their investments; engage in self-dealing transactions with affiliates; permit excessive compensation arrangements; and disenfranchise their shareholders. Nonetheless, the SEC has decided to permit the public offering of hedge fund managers without their regulation under any of the provisions of the ICA.

In the wake of Blackstone's IPO last month, at least two more hedge fund managers have filed registration statements and more are likely to do so in the near future. Congress should act promptly to ensure that publicly sold hedge fund managers are subject to appropriate regulation under the ICA. This can be accomplished by causing the SEC to recognize that these firms are investment companies under the ICA, which would require that they obtain exemptive relief from the agency before offering

[73] *See* Matthew Fink, ICI President's Report at the 1999 General Membership Meeting (May 21, 1999) ("our industry supported the SEC in helping the Investment Company Act of 1940 become law. This spirit of integrity is captured in the words of an industry leader in the 1930s, Arthur Bunker, who testified before Congress. 'We recognize that abuses have existed and we believe that legislation is necessary to . . . help the better elements of the industry to raise the standards of the industry to increasingly higher levels.' Working together, SEC officials and industry representatives took snapshots of the industry. The law that resulted-the Investment Company Act of 1940-made the fund industry's best practices mandatory for all, and flatly prohibited the abuses of the 1920s. As a result, we have a regulatory system whose core protections-oversight by independent directors, bans on affiliated transactions, daily marking to market of assets, limits on leveraging, and full disclosure-are unparalleled in the financial services world.").

their shares to public investors. Alternatively, Congress could create a new category of investment company that was subject to limited regulation under the ICA.

Mr. KUCINICH. I thank the gentleman.
Professor Coffee, you may proceed.

STATEMENT OF JOHN C. COFFEE, JR.

Mr. COFFEE. Thank you, Chairman and members of the committee, for inviting me to be here.

My message is simple. This is the Oversight Committee, and the Blackstone approach to going public needs a great deal of oversight. I am not recommending legislation, and I, in my comments, urge the committee and regulators to always use the least drastic means available to realize the regulatory objective. I also happen to be a supporter. I believe that private equity funds and hedge funds are among the most successful, dynamic performers in our financial services industry, but I do think there is a problem. The Blackstone offering has established a template for future offerings by managers of private equity funds and hedge funds. Already others are lining up and there is a race to rush to the window before it closes.

Unfortunately, that template has three elements that represent the worst imaginable corporate governance. As has already been pointed out, there are no meaningful voting rights. Beyond that, the founders of the firm have the right to remove any of the directors at any time if they act together jointly.

Second, there is no independent board. Indeed, there is neither a nominating committee nor a compensation committee that has any independence. That to me is totally against the trend which the business community, itself, has come to and accepted that independent directors are necessary for publicly held investments because that is where the ultimate protection and the legitimacy enterprise comes from, oversight by independent directors.

Finally, there is no meaningful fiduciary duties owed to the investors because the partnership agreement has exploited all the potential under Delaware law to cancel the normal fiduciary duties. That is because Delaware law regards a partnership agreement as really a private contract among a small, limited number of people, not a mechanism by which thousands of investors are asked to trust other people's money, in effect, to financial managers who do face significant conflicts of interest.

Thus, voiceless, voteless, and stripped of legal remedies, Blackstone's investors must remain passive. There is not even the usual possibility of a control contest, because no one can vote more than 20 percent.

Now, how did this unique and I have said pathological governance structure arise? You can attribute it to one of two things: one, that the company is deemed to be exempt from the Investment Company Act. I would like to get this committee's attention beyond the Investment Company Act. I think we are a little too obsessed with just the Investment Company Act. The problem here is basically one of corporate governance. There is little transparency and no accountability under the governance structure that Blackstone has put in place and that others are rushing to copy.

The other reason why there is this pathological structure is that Blackstone was not subject to the usual corporate governance standards required by the New York Stock Exchange and NASDAQ

because it went public as a limited partnership, not as a corporation. While the critics have all focused on the Investment Company Act, I think the Investment Company Act, frankly, is a remedy that can sometimes be worse than the disease when it is applied to those entities that are at least at the margin of its possible coverage.

You could make this an investment company and then exempt Blackstone from most of the rules under the Investment Company Act. That would work. But I think it is much simpler and more direct to focus on what we want to achieve. I believe what we want to achieve is greater accountability, greater transparency, and that can be done by simpler ways than imposing the investment company straightjacket on this particular entity.

Now, how do we get to this goal of greater accountability and greater transparency? I think the simple problem here is that partnerships are never subjected to normal corporate governance standards because in the past partnerships very seldom went public. When we have seen publicly held partnerships, they were used basically to hold passive pools of investments—real estate, oil and gas, timber. There aren't serious corporate governance problems there. But Blackstone is an operating company that is basically restructuring companies, not holding a passive pool of investments; therefore, what should we do?

Well, besides State law the other mechanism by which corporate governance standards are imposed on publicly listed companies are the rules of the stock exchanges, both New York and NASDAQ today. The New York Stock Exchange since its inception has had minimum corporate governance standards, but it has had no reason to apply them to partnerships because they were a tiny aspect, probably no more than 1 or 2 percent of all listed companies.

The New York Stock Exchange, under influence of Congress, under the oversight of Congress, did move to adopt strong independence standards requiring an independent board, and it is a majority independent board; entirely independent nominating, audit, and compensation committees; and a lead director and a process for annual evaluation of the chief executive officer. All of that is in the interest of investigators. The business community does not resist this.

The typical American public corporation today has 10.4 directors and over 8 of them are independent. That is not the law; that is the norms established by the business community and respected by them. But a partnership is exempt from that.

This didn't arise by any conscious decision to exempt partnerships; it arose by the unconscious design, the unconscious fact that there was no need to develop governance rules for partnerships. Today there is. I think this is a process that needs oversight.

I think in the past we have seen the SEC, under Chairman Arthur Levitt, go to the exchanges and ask them to upgrade their governance standards. He did that with respect to the one-share/one-vote rules, where the court struck down the mandatory rule but Chairman Levitt was able, through diplomacy, to convince the exchanges to adopt minimum rules to protect shareholders' voting rights.

I think the exchanges should be invited before this committee to explain whether they are satisfied with the idea that shareholders would have no independent voting rights; no right to a majority of independent directors; no compensation, audit, or nominating committee that was independent; and no other rights that are traditionally associated with publicly held companies.

I think that is in the long-term national interest because the market works best when we have the oversight of independent directors. That is the least drastic means, and I think we should move in the direction of trying to implement that particular remedy.

Thank you.

[The prepared statement of Mr. Coffee, Jr., follows:]

Testimony of Professor John C. Coffee, Jr.

Adolf A. Berle Professor of Law

Columbia University School of Law

Before the

Subcommittee on Domestic Policy

of the

Committee on Oversight and Government Reform

United States House of Representatives

on

"After Blackstone: Should Small Investors

Be Exposed to Risks of Hedge Funds?"

July 11, 2007

Introduction

Chairman Kucinich, Ranking Member Davis, and members of the Subcommittee, I want to thank you for inviting me to testify today. Important issues are under examination, and I am honored to have been asked to participate.

At the outset, I want to focus on what should and should not be the issue before this Committee. The relevant issue is not the initial public offering of The Blackstone Group L.P. ("Blackstone"); that is a fait accompli. For better or worse, it is history. I submit that the issue for the future is whether that Blackstone offering should become the template for a host of other offerings by other private equity firms and/or hedge funds. At the same time, however, I would advise this Committee that it should not define the issue more broadly than necessary by asking whether public investors should be allowed to invest in hedge funds, hedge fund managers or other functional substitutes for hedge funds and private equity funds. That smacks of paternalism. The SEC is well past the day—and properly so—when it could insist that investors had to be protected (against their will) from exposure to risks that were adequately disclosed.

The real problem with the Blackstone offering, particularly as a likely model for future offerings, is not that it allows public investors to acquire arguably indirect interests in hedge funds, but that it allows them to accept high risk with no accountability or transparency. My message to this Committee is simple: Resist the temptation to recommend sweeping and prophylactic rules; do not try and protect investors from all risk; they do not want such protection. But do require accountability and transparency because, without these, the market over the long run simply does not work. In particular, I urge you to prefer the least drastic means by which to achieve your objective. In the

remainder of my remarks, I will compare the policy options and suggest to you that a focus on listing rules and improved governance is the less drastic option and makes more sense than any attempt to broadly extend the coverage of the Investment Company Act of 1940.

A. Identifying the Problem

Let me put my comments in context. At present, it appears that, in the wake of the Blackstone offering, a stampede of similar offerings is now in progress, as Kohlberg Kravis Roberts & Co. (KKR) and Och-Ziff Capital Management Group LLC have announced plans to go public, and persistent rumors suggest that other firms are on the verge of similar announcements (indeed, an affiliate of the Carlyle Group went public last week on the Euronext NV market in Europe). All in all, this appears to be a giddy, golden era for private equity and similar "alternative investment management companies."

Yet, as this Committee well understands, the Blackstone offering had a number of unique and troubling features from a corporate governance perspective. Among these, three stand out:

(1) The investors received no meaningful voting rights. Specifically, they elect neither the CEO of their firm nor the board of directors of the general partner. Even to the limited extent that they are permitted to vote, they will be systematically outvoted by the 76.4% of the voting rights retained by the insider/founders of Blackstone.

(2) The investors will not be protected by an independent board of directors. Blackstone's initial board is composed of a majority of insiders (with three independent directors—Brian Mulroney, William Parrett, and Lord Nathaniel

Rothschild—having been added just prior to the offering). Moreover, Blackstone's founders—Stephen Schwarzman and Peter Peterson—retain the power, acting together, to appoint and remove the directors of the general partner. Although the board of Blackstone's general partner will have a conflicts committee, its mandate is limited to review of "specific matters that our general partner's board of directors believes may involve conflicts of interest,"[1] and the composition of this committee is not stated in the prospectus. In short, the committee will review only what it is asked to review by the insider-dominated board. Thus, the normal NYSE rules requiring independent nominating and compensation committees have been sidestepped.

(3) <u>The investors are not protected by the fiduciary duties that apply to corporate officers or directors (or even to most partnerships)</u>. The Blackstone limited partnership agreement "limits the liability of, and reduces or eliminates the duties (including fiduciary duties) owed by our general partner to our common unitholders and restricts the remedies available to common unitholders for actions that might otherwise constitute breaches of our general partner's duties."[2]

All told, the investors are denied the voting rights, independent board, and fiduciary duties that protect investors in virtually all other publicly held entities. In addition, there will be no annual meeting at which investors can voice their opinions and no right to information (such as shareholders normally have pursuant to Section 220 of the Delaware General Corporation Law).

[1] See Form 424 B4, filed June 25, 2007, at p. 197.
[2] Id. at cover page.

Nonetheless, this is the template that others are likely to follow (at least in a euphoric market) in the ongoing rush to quickly take "private equity" firms public before the current market window closes. Worse yet, the very nature of the private equity business involves inherent conflicts of interest, over issues such as executive compensation, that suggest that the need for accountability and independent review is even greater than normal in the case of these entities. Indeed, it is likely that Blackstone will need to increase significantly its current levels of executive compensation to retain key personnel. As a result, Blackstone's management will be able to set their own executive compensation without oversight or input from their investors.

From the standpoint of corporate governance, this is a throwback not simply to the era before Sarbanes-Oxley, but to the era before even the Securities Exchange Act of 1934. Voiceless, voteless and stripped of legal remedies, Blackstone's investors must remain passive and, if dissatisfied, have no option but to sell their units. Moreover, there is no prospect, even in the distant future, of a corporate control contest—whether by takeover or proxy fight—because no shareholder (other than the founders) may vote more than 20% of the shares. This is a more severe limitation than the traditional "shareholder rights plan" (or "poison pill") because under well-established Delaware law a poison pill cannot be used to block a proxy contest; thus, a new board can be elected and then remove the poison pill by redeeming it. In all respects, the current management of Blackstone is insulated and largely exempt from all the usual mechanisms of corporate accountability.

B. The Policy Options

The pathological governance structure at Blackstone can be attributed to one or both of two reasons, each debatable:

(1) Blackstone asserts that it was exempt (and was so deemed to be exempt by the SEC) from the Investment Company Act of 1940; and

(2) Blackstone was not subject to the usual corporate governance standards of the NYSE because it is a limited partnership, not a corporation.

Blackstone's critics have largely focused on the first exemption and have argued that Blackstone should be subject to the Investment Company Act of 1940 ("ICA"). I believe the applicability of the ICA to the Blackstone offering is a debatable question, on which reasonable minds can disagree, but I am not convinced that Blackstone should have been classified as an "investment company"—for two distinct reasons. First, my assessment differs from that of other able witnesses before this Committee because I do not consider Blackstone to qualify under either relevant statutory definition of an "investment company."[3] Nor in this regard do I consider "carried interest" necessarily to be an investment security.[4] The latter issue is an especially technical one, which I do not think

[3] The ICA contains two relevant definitions of a security. ICA Section 3(a)(1)(A) defines an investment company to be an issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." In my judgment, that is not what Blackstone or other private equity firms do. They are not passive investors, but active managers that restructure firms and employ an active, "hands-on" approach. The second relevant definition—Section 3(a)(1)(C)—uses a 40% test and asks whether the issuer "owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of Government securities and cash items…." While this second definition also contains additional requirements, the 40% test in the case of Blackstone would depend on the status of its "carried interests"—are they "investment securities?" On this issue, see note 4 infra.

[4] In his testimony, Professor Mercer Bullard argues that "carried interests" are securities. I have high respect for Professor Bullard and I am aware of no case law that disproves his contentions. Nor am I aware of any case law that truly supports them. I do agree that investments in hedge fund managers, who are principally compensated through a share of the profits of the hedge fund, have economic characteristics resembling those of the hedge fund—but not entirely. The investors in the hedge fund manager share the "upside" with the investors in the hedge fund, but not the "downside"; that is, the investors in the hedge fund can lose their capital, but the investors in the hedge fund managers will simply not receive their share of the non-existent profits from that fund (but may still profit from their share in other funds). On this basis, Professor Bullard says that the investors in the hedge fund manager actually hold a "call option." Ingenious

should be the principal focus of this Committee's attention. Second, my dissatisfaction with attempts to characterize Blackstone as an "investment company" stems from the fact that the ICA is today a straitjacket—a cumbersome, antiquated and, in some respects, arbitrary statute whose application to private equity firms would prevent them from going public even if they had model corporate governance provisions. Whatever were the justifications for the ICA's adoption in 1940, the ICA has over time undergone the familiar pattern of statutory obsolescence that affects many statutes. I do not suggest that it be repealed, but it need not be applied to all new investment vehicles that surface from time to time by stretching this statute to the limits of its logic—and beyond.

The basic problem with the ICA (and its corollary the Investment Advisers Act of 1940 (the "IAA")) is that these two statutes broadly discourage investment vehicles subject to them from:

(1) holding a "concentrated" undiversified portfolio;

(2) owning illiquid securities (even if the potential for profit is very high);

(3) engaging in otherwise lawful short sales;

(4) using more than a trivial degree of leverage; or

(5) paying performance fees contingent on the amount of profits (a practice that is universal in the private equity field, with most firms charging a standard fee equal to 20% of profits over a defined hurdle rate).

As a result, mutual funds (regulated by the ICA) differ from hedge funds (not subject to the ICA) in that (a) mutual funds do not typically hold concentrated positions in their

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and clever, this argument proves too much. If it is valid, every parent corporation holds a call option in its subsidiary, and its actively managed subsidiary would thus become an investment security. At this point, the ICA applies to everything. More than an economic resemblance is necessary before compensation for services becomes an investment security.

portfolio companies (limiting themselves to 1% to 2% positions to retain their diversified character), while hedge funds may acquire up to 10% blocks in a limited number of companies; (b) mutual funds generally invest no more than a small portion of their portfolios (roughly 15% as the result of SEC guidance) in illiquid securities, while hedge funds may be heavily invested in such securities, because they do not face daily, or even short-term, redemption calls from their investors; (c) mutual funds use little leverage, while hedge funds can be leveraged up to their eyeballs; (d) hedge funds often sell short, while mutual funds do not; and (e) hedge funds compensate their managers with contingent fees based on their investment performance. In contrast, because mutual funds are subject to the IAA, they can only pay a much more modest "fulcrum fee."[5] In my judgment few, if any, private equity firms would go public if "fulcrum fees" set the ceiling on the maximum fee that a private equity firm could earn. In short, the IAA's ceiling on performance fees would be simply unacceptable to the industry. Thus, to subject the managers of private equity funds (such as Blackstone) to the ICA is ultimately to preclude public offerings by them (and thus restrict their size and growth)—and this may be the ulterior goal motivating at least some of Blackstone's critics.

At this point, the real social costs of an overly restrictive approach to hedge funds and private equity funds comes into full view: such a policy will deter the growth and evolution of a dynamic sector of the American financial services industry. Hedge funds and private equity funds are playing a valuable role, although in so doing they do generate controversy and make enemies. In particular, hedge funds have proven to be a

[5] Advisory fees are regulated by Section 205 of the Investment Advisers Act of 1940 (the "IAA"). Rules 205-1 and 205-2 (17 C.F.R. § 275.205-1 and 205-2) thereunder permit "fulcrum fees," which involve averaging the investment adviser's fee over a specified period, increasing <u>and</u> decreasing the fee proportionately with the investment performance of the fund in relation to the investment record of an appropriate index of securities prices.

positive force in corporate governance, precisely because they can take large equity stakes, and today they constitute the most activist class of institutional investors. In the field of corporate governance, they are vastly more proactive than mutual funds, which tend to be passive investors. One of the reasons for their greater activism is the high fees that incentivize them.[6]

Similarly, private equity funds often buy out the public's interest (at a premium) in troubled firms and seek to rehabilitate them for an eventual re-introduction into the public markets. Typically, this cycle may take five to seven years, and only a firm with high incentives would accept this long a period of risk and illiquidity. Private equity firms have also become controversial because their typical mode of operation often involves a financial restructuring and likely layoffs and plant closings. Still, controversial as they may be, this does not make fund managers such as Blackstone too "risky" for public investors. Other fund managers (such as T. Rowe Price) have long been public. The difference between T. Rowe Price and Blackstone is simply that the former receives a flat 1 or 2% fee based on assets under management, while the latter receives a contingent fee based on profits (as measured typically against some hurdle rate). Yes, a Blackstone is riskier than a T. Rowe Price, but that is not a reason to put such an investment wholly beyond the reach of public investors—if adequate accountability and transparency were assured.

Although hedge funds have had some spectacular failures (the obvious example being Long Term Capital Management), the dot.com bubble that burst in 2000 caused far greater losses to investors, and the Enron/WorldCom scandals of 2001-2002 certainly

[6] For such a view, see Marcel Kahan and Edward Rock, Hedge Funds in Corporate Governance and Corporate Control, *155 U. Pa. L. Rev. 1021 (2007)*.

justified major reforms (most notably, the Sarbanes-Oxley Act), but no one has yet suggested that investments in large corporations be placed off limits for public investors. Still, that would be the practical consequence of stretching the ICA so that it covered the managers of hedge funds and private equity funds: i.e., public investors would not be able to invest in a Blackstone or a KKR & Co.

C. The Preferred Option

If reading the ICA to apply to fund managers seems overly prophylactic and paternalistic, what then is the answer? Here, let's remember the second reason that the Blackstone offering lacked the minimal corporate governance features that normally characterize initial public offerings: the NYSE's corporate governance listing standards only apply to corporations—and not to partnerships. But, while this statement defines the problem, it provides not even a flimsy rationalization for why there should be such a day-versus-night difference in listing standards. In truth, publicly held partnerships are not that common. To the extent that they are listed, they usually hold inactive portfolios of oil and gas, or timber properties, or real estate. Less active management is required. Hedge funds and private equity fund managers are considerably more proactive, hands-on managers and are also subject to far greater conflicts of interest. In short, there is no valid rationale for the current sharp disparity between the extensive, post-Sarbanes-Oxley listing requirements that both the NYSE and Nasdaq have adopted for public corporations and the complete absence of such requirements in the case of publicly held partnerships.

Nor are comparable listing requirements that difficult to draft for publicly listed partnerships. The NYSE and Nasdaq could require that a publicly held partnership have a single corporate general partner with (1) a board of directors that was majority

independent, (2) independent nominating, audit and compensation committees, and (3) minimum defined voting rights. To be sure, the insiders could still retain a majority of the stock (or could use a dual class capitalization to give themselves greater voting power), but that is true in the case of public corporations as well. Moreover, any heavy-handed use of such tactics would likely lower the stock's market price.

Given that there is no serious justification for exempting publicly held partnerships from similar corporate governance requirements to those applicable to corporations, what should the SEC do? Here, the issue becomes more complicated. Under the D.C. Circuit's decision in Business Roundtable v. S.E.C., 905 F.2d 406 (D.C. Cir. 1990), which invalidated an SEC attempt to adopt a mandatory "one-share, one-vote" rule as a listing condition for exchange-listed companies on the grounds that it exceeded the SEC's authority under Section 19(c) of the Securities Exchange Act of 1934, it must be recognized that the SEC cannot simply impose corporate governance listing requirements on the exchanges. Yet, even in the wake of the Business Roundtable decision, then SEC Chairman Arthur Levitt skillfully negotiated an agreement among the three major exchanges (NYSE, Nasdaq and Amex) in order to adopt a uniform, but limited, rule that precluded actions by listed companies that reduced shareholder voting rights.

Similar diplomacy now seems in order. The SEC should request the exchanges to reconsider their listing rules in light of the Blackstone offering. Undoubtedly, there will be some resistance, but Congress could, of course, revise Section 19(c) to give the SEC greater authority. There is no true Constitutional problem with such a legislative change, and its mere threat may produce change. The first step is probably oversight. This

Committee might ask the NYSE (and Nasdaq) why it (they) think publicly held partnerships should be entirely exempt from all corporate governance requirements.

My belief is that this issue has never seriously been considered because it arose so infrequently. But it is about to arise again and again. Yes, the exchanges will resist SEC pressure because they fear that it may drive some fund managers to go offshore. But for major fund managers that wish to make large scale public offerings, that risk is remote. A U.S. IPO will give them a higher price and greater liquidity.

To sum up: I urge you to resist the notion that the Investment Company Act is a panacea, whose extension to hedge funds and private equity funds will solve all problems. In fact, its extension might well drive firms offshore. The better answer is to focus on the narrow abuse—weak to nonexistent corporate governance—and not seek to cripple the evolution of private equity firms.

Mr. KUCINICH. I want to say to Professor Coffee I think that you have made a worthwhile suggestion here to the committee with respect to asking the New York Stock Exchange and NASDAQ questions such as the ones that you have raised. Thank you, sir.

Mr. Borg.

STATEMENT OF JOSEPH P. BORG

Mr. BORG. Thank you. Chairman Kucinich, members of the subcommittee, I appreciate the opportunity to testify today on an issue of importance to retail investors.

State securities regulators have a special appreciation for the plight of everyday investors who are confronted with a bewildering array of new and complex investment products. We are the only securities regulators who interact with and advocate for individual investors on a personal basis each and every day. In short, we are uniquely qualified to address the potential impact of making alternative investments such as hedge funds widely available to the average individual investor.

My remarks should not suggest to you that I believe the retail investing public is unable to properly evaluate investments, nor am I suggesting that regulators should adopt a paternalistic approach and withhold alternative investments from the average retail investor.

What I do suggest to you today is the following: new investments with highly complex structures, opaque investment strategies, and dubious profitability have arrived on Main Street. Precisely because of this trend, the investigator protections afforded by statutes like the Investment Company Act are more important than ever.

Due to a nearly complete lack of transparency, the level of individual and systemic risk attached to these instruments remains unknown to the individual investor. Their fee structures and lack of full disclosures obscure real returns.

The structure of these new instruments places investors in a vulnerable position subject to the whims of controlling persons and literally without recourse. In light of the complexity and uncertainty surrounding these instruments, allowing them to be offered to the public without appropriate regulatory protections poses serious risks to the investors.

As a threshold matter, we believe that public offerings by private equity firms or hedge funds must provide full transparency and investor rights and protections. More particularly, we believe that private equity firms engaging in public offerings, when structured as Blackstone is, should be subject to the requirements of the Investment Company Act of 1940.

While the Securities Acts of 1933 and the Securities and Exchange Commission Act of 1934 protected investors from potential abuse by corporate managers and financial intermediaries, they could not adequately protect investors from abuses by organizers of pooled instrument vehicles. Congress enacted the ICA to impose additional layers of protection for investors, including independent boards, fiduciary duties, shareholder rights, heightened disclosures, restrictions on permissible investments, and even limits on fees and loads.

Offerings such as the Blackstone IPO circumvent the governance protections that the ICA mandates, even though it is no longer a private investment company. For example, under the ICA a fund must have independent directors who represent the interests of public investors. Additionally, investors are protected by the fiduciary duty that attaches to officers and directors. Neither is the case with Blackstone.

We must remember that the securities laws favor substance over form and disdain structures whose only purpose is to evade their reach. In reality, both pre-and post-IPO, Blackstone functions as an investment company that earns its income through investments. From an investor protection standpoint, we are puzzled by the exclusion Blackstone enjoys from the safeguards mandated under the ICA.

The SEC has viewed this type of structure broadly and flexibly since the enactment of ICA. My written testimony cites a number of legal opinions where the SEC recognized that even funds engaged to a significant degree in "special situations," as is Blackstone, qualify as investment companies. For decades, the SEC has been guided by "In re: Tonopah Mining Company," which set forth five factors to determine whether a company was operating as an investment company: the company's history, its public representations, the activities of its officers and directors, the nature of its assets, and the sources of its income, all of which serve as a proxy for what a reasonable investor would believe to be an investment company.

Tonopah identified the most important factor as whether the nature of the assets and income of the company was such as to lead investors to believe that the principle activity of the company was trading and investing in securities. We believe that Blackstone meets this test. The Blackstone structure, now being copied by others seeking to "go retail" appeals to mask the nature of the assets and income of the company in order to avoid the strictures of the ICA and to allow its continued operation as a de facto private company. Neither goal serves the interest of investors or marketplace.

The new entities attempted to escape the conclusion that they are investing companies through a purely structural maneuver: adding a new layer in its corporate form, Blackstone LP, and then selling units in Blackstone LP to the public. But measured by the true nature of its activities and its investment holdings, the Blackstone structured entities should be regulated as investment companies.

The prospectus makes it clear to investors that they will share in the rewards and bear the risks of Blackstone's investment activities. The point is further reinforced through the identification of the carried interest as a significant source of potential gain for investors.

Presumably, Blackstone would suggest that their offering poses no undue threat to investors because, while it may be risky, those risks are disclosed. The public policy issue is: how much risk, even when disclosed, should be transferred to the general public? In a perfect world a careful financial advisor will say Blackstone type entities are too risky, too opaque, too conflicted, so we won't invest. However, the real world operates much differently. Securities sales-

persons sell whatever their firms tell them to sell. They are not likely to delve deeply into disclosed risks with the customer sitting across the kitchen table.

The IPO disclosures come dangerously close to an affirmative statement by Blackstone that it will conduct its business in whatever way it chooses, and that the investors must waive any rights or remedies for such conduct. It is precisely for these reasons that Congress enacted the ICA, not just to ensure disclosure, but to impose affirmative duties on such companies and to delineate boundaries in the operation of these inherently risky enterprises.

In the Blackstone IPO, which apparently now will be followed by KKR, Och-Ziff Capital, and others, a fundamental purpose of the ICA is imperiled. That purpose is the protection of the investing public from the potential risks of investment pools. When private speculators turn to the public markets for capital, what Justice Brandeis called "other people's money," they cannot continue to operate as if they were still a private concern.

In conclusion, I want to emphasize that NASAA does not object to access to alternative investigations by retail investors so long as they are accompanied by all appropriate and necessary investor protections, rights, and remedies. This can only be accomplished by ensuring such investments are offered pursuant to the appropriate act.

Your constituents, America's retail investors, are not accustomed to the realities of alternative investments, portfolios of illiquid securities, the use of substantial leverage, concentration of investments, and excessive compensation arrangements detrimental to their interest. Congress sought to eliminate these elements of alternative investments from the public marketplace. Surely, your and our constituents are still deserving of the protections so wisely provided to them.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Borg follows:]

TESTIMONY OF JOSEPH P. BORG

Director, Alabama Securities Commission

And

President of the
North American Securities Administrators Association, Inc.

Before the

United States House of Representatives

Committee on Oversight and Government Reform

Subcommittee on Domestic Policy

"After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds?"

July 11, 2007

Chairman Kucinich, Ranking Member Issa, Members of the Subcommittee,

I'm Joe Borg, Director of the Alabama Securities Commission and President of the North American Securities Administrators Association, Inc., better known as NASAA.[1] I appreciate the opportunity to testify today on an issue of importance to retail investors.

Introduction

Let me begin with a brief overview of state securities regulation, which actually predates the creation of the Securities and Exchange Commission (SEC) and the NASD by almost two decades. State securities regulators have protected Main Street investors from fraud for nearly 100 years. The role of state securities regulators has become increasingly important as over 100 million Americans now rely on the securities markets to prepare for their financial futures, such as a secure and dignified retirement or sending their children to college. Securities markets are global but securities are sold locally by professionals who are licensed in states where they conduct business.

In addition to licensing, state securities regulators are responsible for registering some securities offerings, examining broker-dealers and investment advisers, providing investor education, and most importantly, enforcing our states' securities laws.

Similar to the securities administrators in your states, the Alabama Securities Commission prosecutes companies and individuals who commit crimes against investors, and brings civil actions for injunctions, restitution, and penalties against companies and individuals who commit securities fraud. Another of our responsibilities is to order administrative actions to discipline brokers and firms who engage in violations of rules and regulations by selling unsuitable investments, charging excessive fees, and otherwise taking advantage of investors.

State Securities Regulators Have a Unique Understanding of the Challenges and Risks Confronting Investors

State securities regulators have a special appreciation for the plight of everyday investors who are confronted with a bewildering array of new and complex investment products. We are the only securities regulators who interact with, and advocate for, individual investors on a personal basis each and every day. We read their complaint letters, listen to their phone calls, and conduct in-person interviews with them – often in their homes – all to ensure that their individual complaints and questions are addressed. We also hold

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexieo, and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

interactive "town meetings" and investor education events. While these events allow us to provide your constituents with valuable investor education, they also provide us with the opportunity to listen and gain valuable insight into their thought processes regarding investments and investment decision-making. In short, state securities regulators are uniquely qualified to address the potential impact of making alternative investments such as hedge funds widely available to the average individual investor.

It is our experience that the vast majority of individual investors who would characterize themselves as "actively engaged" in their investments do not buy securities – rather they are sold securities. In other words, most individual investors rely upon the recommendations of salespersons or the media hype surrounding a particular instrument when making investment decisions.

It is now common knowledge that the average retail investor will not read and cannot understand the typical prospectus. Due to the length and complexity of these documents, retail investors have by necessity come to rely upon the representations of salespersons or easily digested media characterizations.

Additionally, there are vast numbers of individuals who are entirely passive in the selection of their investments. Many of our nation's school teachers, fire fighters, policemen, and other state, county, and municipal employees rely upon professional advisers to manage their pension funds wisely.

My remarks should not suggest to you that I believe the retail investing public is unable to properly evaluate investments. Nor am I suggesting that regulators should, by adopting a paternalistic approach, withhold alternative investments from the average retail investor. What I do suggest to you today is the following: New investments with highly complex structures, opaque investment holdings and strategies, and dubious profitability have arrived on Main Street, and precisely because of this trend, the investor protections afforded by statutes like the Investment Company Act are more important than ever.

Currently, the world's leading financial experts cannot agree on either the risks or the merits of many of these investments. Due to a lack of transparency, the level of individual and systemic risk attached to these investments remains unknown to the individual investor. Fee structures and lack of full disclosure obscure real returns. The structure of these new instruments places investors in a vulnerable position, subject to the whims of controlling persons, the lure of past performance "promises", and literally without recourse. Even the very basic threshold questions of what these new instruments are and what federal registration provisions apply to them appears to have confounded those charged with making such decisions. In light of the complexity and uncertainty surrounding these instruments, allowing them to be offered to the public *without* appropriate regulatory protections poses serious risks to investors.

The Investment Company Act Offers Vital Protections Against the Risks Inherent in the Public Offering of Alternative Investments

As a threshold matter, we believe that when private equity firms engage in public offerings they should be subject to the requirements of the Investment Company Act of 1940 ("the ICA"). The ICA is a shield, protecting main street investors against the potential misuse of their invested funds. It also helps to inoculate the market as a whole – and our economy – against the harm that purely speculative financial interests can sometimes have and the loss of investor confidence that often results.

In 1936, Congress recognized that the Securities Act of 1933 and the Securities Exchange Act of 1934 were insufficient to protect investors from the unique risks posed by investment pools. These pooled investment vehicles, or investment companies, posed special problems to the investing public. As unregulated entities, the investing public was required to accept the representations of the managers on blind faith. While the Securities Act of 1933 and the Securities Exchange Act of 1934 protected investors from potential abuse by corporate managers and financial intermediaries, they could not adequately protect investors from abuses by organizers of pooled investment vehicles. After an exhaustive four-year study, Congress enacted the ICA to impose additional layers of protection for investors, including independent Boards, fiduciary duties, shareholders rights, heightened disclosures, restrictions on permissible investments, and even limits on fees and loads. While mutual funds are the classic and best understood type of investment company, companies such as leveraged buyout funds have traditionally been considered investment companies. However, until now, the risks associated with these funds have been limited because they have always functioned as either private investment companies or they have relied solely on investments from qualified purchasers. The public offering of these investments raises new and serious concerns for millions of everyday investors.

The Blackstone IPO, as the most prominent representative of these vehicles, circumvents the governance protections that the ICA mandates, even though it is no longer a private investment company. For example, under the ICA, a fund must have independent directors who represent the interests of public investors. That is not the case with Blackstone. It is critical to understand that in reality, both pre and post IPO, Blackstone functions as an investment company that earns its income through investments. There is no basis for exempting Blackstone from the protections mandated under the ICA.

The SEC Has Taken a Consistently Broad View of What Constitutes an Investment Company

The SEC has viewed this type of structure broadly and flexibly since the enactment of the ICA in 1940. The SEC made the following findings in its Tenth Annual Report issued in June 1944:

<u>The "Investment Company" concept</u>

Although the terms "Investment company" and "Investment trust" have been part of the language of the financial community for some time, a definition precise enough to distinguish them sharply from holding companies on the one hand and operating companies on the other did not exist prior to the enactment of the Investment Company Act of 1940. The distinctive feature of the Act in this connection is its use of a quantitative or statistical definition, expressed in terms of the portion of a company's assets which are investment securities. Thus the statute provides, inter alia, that a company is an "investment company" if it is engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and owns investment securities (defined to exclude securities of majority-owned subsidiaries and of other investment companies) exceeding 40 percent of its total assets (exclusive of Government securities and cash items). However, the Act provides machinery whereby the Commission may declare by order upon application that a company, notwithstanding the quantitative definition, is nevertheless not an investment company. Thus, companies that believe the application of the quantitative test would unreasonably cause them to be classified as investment companies are given the opportunity of obtaining administrative dispensation by showing that they are primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading securities, either directly or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses. Since November 1, 1940 about 50 such applications have been filed. Knotty questions have been raised by these applications, including difficult and complicated problems of valuation especially with respect to the so-called "special situation" companies".

Such an application was filed on behalf of a company, Bankers Securities Corporation, whose portfolio contained securities of companies engaged in a great variety of enterprises, railroads, utilities, banks, newspapers, insurance companies, industrial companies of every kind, hotels, apartment houses, retail establishments, department stores, and many others. Extensive hearings were held before a trial examiner, briefs were filed and oral argument was had before the Commission. The company contended that it was primarily engaged in the real estate and department store business because the bulk of its investments were in those fields. Based upon the history and operations of the company, its investments in special situations, its statements of policy, and other relevant factors, the Commission concluded not only that the record before it fell short of sustaining the claim that the company was primarily engaged in non-investment company business but that the record demonstrated affirmatively that the applicant was organized and always had been operated as an investment enterprise. The applicant appealed from the

> order of the Commission denying the application to the United States Circuit Court of Appeals for the Third Circuit. On November 21, 1944 that Court unanimously affirmed the Commission's order. Bankers Securities Corp. v. SEC, 146 F.2d 88 (3d Cir. 1944)

In its administrative opinion in Bankers Securities Corporation, the SEC recognized that even funds engaged to a significant degree in "special situations" – as is Blackstone – qualify as investment companies:

> In the course of its history, applicant has obtained large and controlling interests in various businesses, disposed of some, and retained others. Its officers have actively managed controlled businesses for the purpose of rehabilitating important investments in the portfolio. This is a well-recognized form of investment company business, known as dealing in 'special situations'. . . . Not only does this record fall short of sustaining applicant's claim that it is primarily engaged in non-investment company business, but it demonstrates affirmatively that Bankers Securities Corporation was organized, and has always been operated, as an investment enterprise. Public investment in the company was invited and has been maintained on representations which meant, in essence, that the company was diversifying stockholders' risk by a varied investment program. Stockholders were not asked to rely on the skill of applicant's management in the merchandising, or in any other specific mercantile or commercial business. They were given to understand that the management was alert always to find profitable repositories of invested funds, and the history of the company bears out the understanding, created in stockholders, that the company was not committing itself primarily to any specific business.

In the Matter of Bankers Securities Corp., 15 S.E.C. 695 (April 7, 1944).

For decades, the SEC has been guided by In re Tonopah Mining Co., 26 S.E.C. 426 (1947). Tonopah set forth five factors to determine whether a company was operating as an investment company – the company's history, its public representations, the activities of its officers and directors, the nature of its assets, and the sources of its income – all of which serve as a proxy for what a "reasonable investor" would believe to be an investment company. Tonopah identified the most important factor as whether "the nature of the assets and income of the company ... was such as to lead investors to believe that the principal activity of the company was trading and investing in securities." Blackstone unquestionably meets this test. The Blackstone structure is intended to mask "the nature of the assets and income of the company" in order to avoid the strictures of the ICA, and to allow its continued operation as a de facto private company. Neither purpose serves the interests of investors or marketplace.[2]

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[2] In a recent interpretation of Tonopah, the Seventh Circuit placed primary emphasis on the perceptions of a reasonable investor: whether the company's assets and income would lead an investor to believe that the

<u>Blackstone Is an Investment Company and Should Be Treated as One for the Benefit of Investors</u>

Blackstone attempts to escape the conclusion that it is and has always been an investment company through a purely structural maneuver: adding a new layer in its corporate form (Blackstone LP) – and then selling units in Blackstone LP to the public. But measured by the true nature of its activities and its investment holdings, Blackstone should be regulated as an investment company. As the prospectus makes abundantly clear, investors are being told they will share in the rewards and bear the risks of Blackstone's investment activities. The point is reinforced through the identification of carried interest as a significant source of potential gain for investors.

Presumably Blackstone would suggest that their offering poses no undue threat to investors because, while it may be risky, those risks are disclosed. The public policy issue, however, is how much risk, even when disclosed, should be transferred to the general public. In a perfect world, a careful financial adviser will say Blackstone is too risky, too opaque, and too conflicted so we won't invest. However, the real world operates much differently. Securities salespersons sell whatever their firms tell them to sell. They are not likely to delve deeply into the "disclosed risks" with the customer sitting across the kitchen table. The IPO disclosures come dangerously close to an affirmative statement by Blackstone that it will conduct its business in whatever way it chooses and that investors agree to waive any rights or remedies for such conduct (see p. 179-181 of the S-1). It is for precisely these reasons that Congress enacted the ICA: Not just to ensure disclosure, but to impose affirmative duties on such companies and to delineate boundaries in the operation of these inherently risky enterprises.

A fundamental principle of U.S. securities law is that of substance over form. This principle is essential to regulators as well as the investing public. This is because it facilitates our ability to stay ahead of the myriad ways that speculators will attempt to separate people from their money. The securities laws, including the ICA, are remedial in nature. Their purpose is to protect investors and to act as a shield between the economy and financial speculators. Congress intended that the SEC not ignore the substance of an investment, and look beyond its form if a fundamental purpose of the law may be imperiled.

In the Blackstone IPO (which apparently will now be followed by offerings by Kohlberg Kravis Roberts & Co. and Och-Ziff Capital Management), a fundamental purpose of the ICA – protection of the investing public from the potential risks of investment pools – is imperiled. When private speculators turn to the public markets for capital, what Justice Brandeis called "other people's money," they cannot continue to operate as if they were still a private concern.

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company was an investment company. Even under this novel and perhaps overly subjective view, Blackstone still falls within the ambit of the ICA. <u>SEC v. Nat'l Presto Indus.</u>, 486 F.3d 305 (7th Cir. 2007).

Conclusion

Alternative investments have a legitimate place in our financial markets. Indeed, we do not object to access to these investments by retail investors so long as they are accompanied by all appropriate and necessary investor protections, rights, and remedies. This can only be accomplished by ensuring such investments are offered pursuant the appropriate Act. Your constituents, America's retail investors, are not accustomed to the realities of alternative investments: complex capital structures; portfolios of illiquid and difficult to value securities; the use of substantial leverage; concentration of investments; self-dealing transactions with affiliates; excessive compensation arrangements detrimental to their interests; and disenfranchisement as shareholders. Congress sought to eliminate these elements of alternative investments from the public marketplace. Surely your constituents are still deserving of the protections so wisely provided to them.

Mr. KUCINICH. Thank you very much, Mr. Borg.

Mr. Tanous.

STATEMENT OF PETER J. TANOUS

Mr. TANOUS. Thank you, Chairman Kucinich and Ranking Member Issa, for allowing me to appear before you today.

Let me make several points relative to the discussion today. The first was made by Congressman Issa earlier, which is the difference between private equity firms and hedge funds. They are in very different businesses, and I won't belabor that point. They have two things in common. One is that they both charge very high fees, and the other is that their liquidity is very limited. In the case of private equity firms, you are basically investing for a number of years.

Now, what are the risks in owning shares of Blackstone, because that is on the table today? We shouldn't confuse the risk of owning the Blackstone management company, we should call it, with the risk of investing in Blackstone funds. They are very different. The people who bought the Blackstone shares are basically buying into a stream of income from the fees that Blackstone earns. That is arguably not very different from the risk any investor takes when an investor buys a company that is competing in the marketplace and is subject to whatever the competitive factors are.

Now, it also has been pointed out that the unit shareholders of Blackstone do not have the same rights as most stockholders do. I don't particularly like that, but the fact is that when an investor decides to invest in it, the investor knows or should know what those limitations are.

I might also point out that there are other examples, such as in the newspaper industry where you have two classes of stocks, and most of the investors have very limited rights with respect to electing the board and other rights.

Are hedge funds safe for the average investor? There is a wide gamut of hedge fund activities and philosophies, and, frankly, they run from very safe to very risky. In our business, though, because they are not at all transparent, we do not want our investors, even very wealthy ones, to take the risk of buying a single hedge fund. We all remember last year the case of Amaranth. This is a case of a hedge fund that was very highly regarded, a lot of very smart people had money with them, and they bragged about how good their controls were, and yet a 32-year-old trader made a big bet on natural gas and lost $5 billion in 1 week and the fund subsequently folded.

For those who are interested in hedge funds, small or large investors, we think they should use funds of funds where the risk is spread out over 20, 30, or 50 separate hedge funds.

Finally, should private equity firms and hedge funds be regulated by the SEC, which seems to be the major topic today? The SEC was created to protect investors, and the American capital systems are the envy of the world as a result of the honesty and integrity of our systems. My firm is registered with the SEC. We file a form ADV once a year, sometimes even more frequently, and we have to disclose lots of things in that form. We have to disclose our board of directors, our shareholders, the nature of our clients, and what not.

Now, I heard—forgive me for characterizing it this way—the legal mumbo-jumbo about why Blackstone is not subject to SEC rules, and I would rather apply a simpler test that was alluded to earlier in this hearing. If it looks like a duck and acts like a duck and quacks like a duck, it is a duck. I suggest that, to me, Fortress and Blackstone are investment ducks, and if my firm is regulated by the SEC I can think of a lot of reasons why they should be, as well.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Tanous follows:]

After Blackstone: Should Small Investors Be Exposed to Risks of Hedge Funds?

Testimony of
Peter J. Tanous
before the
Domestic Policy Subcommittee
Committee on Oversight and Government Reform
U.S. House of Representatives
July 11, 2007

INTRODUCTION

Thank you Chairman Kucinich and Ranking Member Issa for allowing me to testify before your hearing today. I am Peter Tanous, president and CEO of Lynx Investment Advisory LLC here in Washington DC. Lynx is an investment consulting firm founded over 15 years ago. We advise on assets for individuals and institutions totaling in excess of $1.3 billion. I have been in the investment business for over 40 years and I am the author of three books on investments. A fourth will be published in January 2008.

Thank you for the opportunity to share some views with you on the risks faced by investors with respect to hedge funds, private equity funds and IPO's of their management companies. As the CEO of an investment consulting firm, this is a question we deal with frequently.

I would like to make several points:

What is the difference between private equity firms and hedge funds?

What are the inherent risks to investors in owning shares in the companies that run these funds, such as Blackstone? How different are these risks from investing in other types of securities?

Are hedge funds safe for the average investor?

Should private equity firms and hedge funds be regulated by the SEC?

Difference between Private Equity firms and Hedge Funds

On my first point, I would like to distinguish between hedge funds and private equity firms. They are not the same thing. Hedge funds are investment partnerships that can invest in a broad range of investments. They can buy stocks, sell stocks short, buy options and commodities and borrow money to create leverage.

Private equity funds are generally also formed as limited partnerships. But these funds don't usually buy stocks as investments or sell stocks short. They buy entire companies that may or may not be publicly held and take them private. Often these investment firms will take measures to improve the companies and sell them back to the public through an IPO at a higher price, thus making money for their shareholders and themselves.

What both private equity funds and hedge funds have in common is that they both charge very high fees, typically 2% of assets under management (AUM) and 20% of investment profits. They also share another important feature in that liquidity is quite restrained.

Private Equity	**Hedge Funds**
Private equity is primarily geared towards long only investments in whole companies. The investment universe is not vast	Hedge funds can buy and sell short but generally do not buy whole companies. The investment universe and strategies available for a hedge fund is vast
They buy full control, or will at least have high level of control over the firms they invest in	Low or no control
Multi-year horizon: The assets are tied up for many years. They are truly long term investors	Shorter time horizon: The assets are not tied-up for years although liquidity is limited
Little to no exposure to derivatives	Extensive use of derivatives
Holdings are transparent (An investor knows what the fund owns)	Holdings information is guarded and is not transparent (The investor generally does not know what the fund owns)

Both private equity and hedge funds impose limited liquidity on investors as compared to investment in the stock market or mutual funds. Private equity investments often involve a commitment measured not in days or months, but in years. One of the marquis names in private equity, Kohlberg Kravis Roberts, which also plans an initial public offering, says 73% of its assets are committed for as much as 18 years. This long-term commitment gives the firm huge flexibility to ride out tough times. And it provides a steady stream of cash from the typical 2% management fee – alongside the bigger and more volatile 20% share of investment gains.

By contrast, hedge fund investors can take their money out relatively quickly (but in a time frame generally measured in months) if performance is bad, making the underlying fee stream less secure.

In the end, success of both models is dependent on returns. It just happens that private equity groups have a longer time to prove themselves, have real control over their portfolio companies and can ride out most market storms.

Risks to Investors Investing in Companies that Run Private Equity Firms and Hedge Funds

Questions have been raised about the risks in investing in a Blackstone IPO, or equivalent, compared to other types of investments in equities. Investing in the Blackstone offering bears some resemblance to investing in a mutual fund management company. But there are some important differences.

Investors in Blackstone and in mutual fund companies are not buying the funds themselves. The Blackstone Group is trading on the returns and reputation of its managed funds, but what it sold was not a piece of any or all of those funds but rather a piece of the company (advising company) that manages that money. So the investor is not getting the risk or volatility (and returns) of the private equity investments but is investing in the fee part of the business. This fee business is generally stable given the longer term commitment of the investors in the private equity funds. This is similar to investing in any asset management company such as Janus, T.Rowe Price, Legg Mason etc. The private equity management firm can make even more money through the carried interest (the 20% profit share). So in a way, investing in the company that runs private equity funds exposes investors to risks that are not unlike the risks in investing in most other companies. The success of the company derives from the revenues generated. In the case of Blackstone and similar companies, the income consists of fee revenues for the funds, and the investor is not exposed to the risks of investing in the funds themselves. It is a business risk not unlike the business risk an investor incurs when he or she invests in any other type of company competing in the marketplace.

One major difference between a typical IPO and the Blackstone IPO is the way the Blackstone IPO was structured.

Investors have no say in how the company will be run. Since Blackstone Holdings was structured as a master limited partnership, investors are unit holders instead of shareholders. The difference is critical: Shareholders in a publicly held corporation vote to elect company directors, and a public company with shareholders must have a majority of independent directors on its board of directors. Unit holders, as in the case of Blackstone, lack those basic rights. They would not be entitled to vote to elect directors, and master limited partnerships are not required to have a majority of independent directors on the board of directors. The rules of the Blackstone Holdings master limited partnership even allow the directors of the company to sell the business without the consent of the unit holder. The directors also can pay themselves any salary they want since the firm is not required to have an independent compensation committee.

Personally, I am uncomfortable with the very limited rights of unit holders in this type of corporate structure. But it is legal and there are many other examples of companies where shareholders have limited rights as a result of two classes of stock. Many newspaper companies, for example, operate in this fashion in order for a minority of shareholders involved in the business to control corporate decisions. In the end, the investor is free to choose whether or not this arrangement is acceptable, and whether to invest in full knowledge of his or her limited say in the activities of the company.

Are Hedge Funds Safe for the Average Investor?

The biggest fallacy in the discussion about hedge funds is the tendency to paint them all with the same broad brush leading to the following conclusion: Hedge funds are risky investments. The truth is that there are dozens of different hedge fund strategies ranging from the very conservative to the very aggressive. We often hear about the very aggressive nature of hedge funds, particularly when something bad happens to one or more of them. I cover this subject in my forthcoming book, *"Build A Winning Portfolio."* (Kaplan, January 2008). The biggest problem with hedge funds is the lack of transparency. An investor seldom has any idea of what the hedge fund is doing on a day to day basis. The investor is informed of the general strategy, but there are typically enough loopholes in the agreement so that the hedge fund manager can do almost anything he or she chooses to do. In our firm, we strongly discourage investors from buying individual hedge funds. We do so to prevent the risk of a completely unforeseen disaster that no amount of due diligence could foresee. A perfect recent example is the debacle surrounding the demise of the Amaranth Advisors hedge fund. In 2006, a 32 year old energy trader at Amaranth made a huge bet on natural gas that resulted in a $5 billion loss in one week. The fund closed down shortly thereafter. The fund had bragged about its risk controls and other measures to prevent precisely the type of disaster to which it ultimately fell victim. Several prominent Wall Street firms had invested in the Amaranth fund for their clients through internally managed funds of funds. These firms all did the requisite due diligence to ensure that Amaranth's operations were up to par. Yet the disaster occurred.

The Role of Hedge Funds in Diversified Portfolios

While the instruments that hedge funds use might in isolation be risky, the *combination* of instruments in a hedge fund strategy can be rendered fairly safe. Moreover, in the context of the diversified strategies typically found in "funds of hedge funds", risk can be dialed up or down to virtually any desired level. Indeed, hedge funds of funds can be diversified enough and managed with sufficiently little leverage that a conservative fund of funds could be rendered as safe as short-term bonds, which are rather conservative investments. Lynx Investment Advisory, LLC manages a hedge fund of funds with just such a conservative approach – Lynx Partners, LP. Over the course of its five year history, this fund has exhibited less volatility than a standard portfolio of bonds. Of course, more aggressive funds could dial up the risk to pursue more adventurous strategies in pursuit of expectedly higher returns. The risk and return of such an

aggressive fund could be leveraged high enough to render it more risky than a portfolio of highly volatile micro-cap growth stocks.

Thus, hedge funds or, more to the point, hedge funds of funds can adopt strategies of varying risk. Before passing judgment on the efficacy of hedge funds for individual investors, however, it is also important to consider hedge funds in the context of more broadly diversified investment strategies. Hedge funds well may possess distinct characteristics that qualify them uniquely to mitigate the risks of standard types of investments in broadly diversified portfolios. Thus, any investor who holds an array of stocks, bonds, real estate and cash, or mutual funds covering these investment asset classes, could in principle benefit from the risk mitigation that hedge funds offer. And virtually every participant in a pension plan, owner of an IRA or similar investor does own such "plain vanilla" investments. Hedge funds behave very differently from stocks, bonds, real estate and cash – or in technical parlance, have returns that are weakly correlated with the returns on such standard investments. Therefore, including hedge funds as a minor portion of a larger, diversified portfolio can actually reduce the risk of the larger portfolio and increase its potential returns. In short, portfolios that include hedge funds can be more efficient than portfolios that exclude them.

Nonetheless, hedge funds are not for everyone. They are complex investment vehicles that use complex strategies that may be quite difficult to understand. No one should invest in such vehicles without either understanding them on their own or having a trusted advisor who can guide them through the thicket of myriad strategies and offerings available in the marketplace. Thus, it is appropriate and perhaps sufficient to limit these privately offered investments to so-called "accredited investors" who must meet certain income or asset tests or who have other qualifications for assessing the merits of these funds. Lynx Investment Advisory, LLC provides such guidance to dozens of its accredited clients who have chosen to partake of hedge funds as part of a more broadly diversified investment strategy. And thus Lynx serves as their guide through the thicket.

Investors with less experience, with lesser means and with no professional guidance now are prevented from investing in hedge funds. And this prohibition is appropriate. On the other hand, it is now possible to invest in mutual funds that have adopted many hedge-fund like strategies. In principle any small investor could invest in such mutual funds. However, regulations on mutual funds limit their latitude for borrowing, for leverage and for short-selling. Thus, the risk in these mutual funds is quite comparable to the risk of similar "plain vanilla" mutual funds that merely buy stocks and bonds in their portfolios without leverage, short sales or other hedge-fund tactics.

Should Private Equity firms and Hedge Funds be regulated by the SEC?

In my opinion, this debate boils down to the larger question of whether or not investors should be afforded some degree of oversight and protection by the appropriate regulatory authorities. In my opinion, the answer is: yes. Indeed, that was the purpose for the

creation of the SEC and subsequent legislation that followed. As a result, the American capital markets are the most respected and trusted in the world, largely because of the scrutiny and honesty that we impose on the process of offering and selling securities in this country.

My firm, like many others in our business, is registered with the SEC as an investment advisor. We are required to file annually, or in some cases more frequently, Form ADV with the SEC. This form requires us to disclose relevant information about our business including assets under management, ownership, directors, number and types of clients, among other things. We are subject to the rules of the Investment Advisers Act of 1940.

Now I have heard the various arguments about why hedge funds should not be regulated. Frankly, I don't get it. I am not an expert on securities law, but my simple analysis is this: If it looks like a duck, walks like a duck, and quacks like a duck, it is a duck. Hedge funds and private equity funds are investment offerings. Moreover, as a class, they are arguably riskier than other types of investment offerings such as stocks and bonds. As such, investors in these instruments should be entitled to the same degree of oversight and protection as are investors in other, and presumably safer, forms of securities.

In concluding, I would like to again thank the committee for allowing me to testify and I would also like to acknowledge the assistance I received from two of my colleagues at Lynx Investment Advisory LLC in the preparation of this testimony. They are Matthew D. Gelfand, Ph.D., CFA, CFP® and Vipin Sahijwani, CFA.

Mr. KUCINICH. I thank the gentleman.

We are going to go to questions from members of the panel. Mr. Tierney, would you like to go first?

Mr. TIERNEY. Well, I think I fall in line with most of the public here. I am not sure that I understand all that I ought to understand about what seems to be a complex issue, but I look at it more from the standard of somebody that has worked all their life and put money into a pension fund, to have those pension fund managers turn around and invest in something like a Blackstone on that. So I guess my question would be: what protections do we have under the current system for those individuals? And what protections ought we have for them?

Professor, we will start with you and just go left to right.

Mr. COFFEE. I think right now the only protection that a pension fund manager investing in Blackstone, the hedge fund manager, not the Blackstone funds, have would be rule 10(b)(5) in the law of fraud. I am not alleging in any way that there is any fraud, but you don't have the usual mechanisms. You don't get to vote. You don't get your right to information. You don't have independent directors owing you fiduciary duties. And there is no prospect that if this management is poor some other management will come in and buy them out and have a control fight. None of that can happen under the way this has been designed, and I think that is a very poor precedent for the future.

My focus is not on Blackstone, but we are opening up a possibility of a whole new asset class, which could be over $100 billion in a few months or years, composed of entities that are in a business that is full of conflicts of interest and there is not any of the traditional mechanisms of corporate accountability applicable to them.

Mr. BULLARD. I would add to that I see your question in the context of it being publicly offered. My view is that if the pension fund were investing in a Blackstone, that by itself Blackstone should be able to do anything it wants and I wouldn't object to any of the provisions that Professor Coffee has mentioned.

I think he is meaning in the context of a public offering, because no one questions it in today's context. A pension fund can invest. It can agree contractually to all of those onerous pathological provisions and I don't think anyone on this table objects to that. What is objectionable is when that vehicle becomes available in the public market.

Mr. COFFEE. I misunderstood your question. He has corrected me. I thought you were asking about investment in the public.

Mr. TIERNEY. I probably wasn't as clear as I should be. As I said, I don't think I understand it as fully as I should. What is the harm to Blackstone if they go out and are treated as an investment company? What is the deal to them? I am telling you, from somebody on the other side that doesn't completely understand all of it, this thing just smells to high heaven. I am looking out there and saying, you know what, this is distasteful. This reminds me of a lot of things that have happened in our history where the small guy gets tucked and somebody else walks away with all the dough. They are taking care of themselves, as the gentleman at the end said, with a lot of mumbo-jumbo, and they are off and running.

So why don't we just regulate them and make them do the things we reasonably make other people do? What is the harm?

Mr. COFFEE. If you were to subject Blackstone to the Investment Company Act, much of what they currently do could not be done without a new form of exemption. For example, that would include that there is a prohibition on incentive fees and that you right now are receiving very high incentive fees based on percentage of profits. That is regulated by a series of rules that treat mutual funds very differently than hedge funds, and they are very different animals. They are not that similar at all in terms of their behavior.

There are restrictions on leverage, and it is the case that a true investment company can't have more than approximately 15 percent of its assets in illiquid investments. All of what Blackstone owns is illiquid investments, so that they would have to have a very different portfolio. There could be exemptions given. I fully agree the SEC could call it an investment company and take 80 percent of it back, but that seems to me going up the hill and back down the hill and accomplishing very little along the way.

My colleague here differs.

Mr. BULLARD. Well, I agree that they simply would not be able to function if they were subject to all the requirements of the Investment Company Act. That being said, I think I would go further than Professor Coffee in pointing out that the exemptive process is a longstanding tradition of the SEC. It has created numerous entities and allowed them to be publicly offered, subject to carefully tailored exemptions. For example, asset-backed securities have a virtually complete exemption from the act. Exchange traded funds exist only because of an exemption from the act. Even more, the multi-class funds with their A, B, and C shares are prohibited by the act. They exist because of an exemption. The 12(b)(1) fees are prohibited by the act. They exist only because of an exemption. Money market funds are prohibited by the act. The only reason that we have only $2 trillion in money market funds is the SEC exemptive authority, and that is a much more efficient way to regulate them than to go to the exchanges to obtain some kind of limited governance reform.

Mr. TIERNEY. Mr. Tanous, I sympathize with what you were saying. If your firm has to register, why don't they? Would you put them under the Investment Act, or would you do some of the other more novel approaches of Professor Coffee?

Mr. TANOUS. Mr. Tierney, I would put them under the Investment Act, but make the exceptions that were enunciated here. That seems to be the best way to do it. The idea of putting them under the Investment Act and saying that now they are going to have to comply with all of the provisions that were written in 1940 obviously doesn't make much sense. But there is a simpler way and more practical way to do this, but they should be regulated.

Mr. TIERNEY. Absolutely.

Thank you all very, very much.

Mr. KUCINICH. Mr. Cannon.

Mr. CANNON. Thank you again, Mr. Chairman. I apologize for going back and forth. We have a high level panel on clemency going on in the Judiciary Committee, which is just next door, and so Mr.

Issa and I are both on both of these committees and are going back and forth. So, again, I apologize for the erratic presence.

I do actually have some questions that I would like to go into with this panel.

Mr. Tanous, could you explain for the committee the concept of investing in funds of hedge funds and what this type of investing does to insulate—I am sorry, we don't want to ask that question.

Mr. TANOUS. I would be happy to answer.

Mr. CANNON. What I would rather ask is this: would you agree that organizations like Blackstone are nothing like Long-Term Capital Management, and therefore comparisons between the two are flawed?

Mr. TANOUS. Yes. I don't think they are anything like Long-Term Capital Management. The Long-Term Capital Management blow-up was largely an issue of very high leverage, and that, to my knowledge, is not at all the case with respect to Blackstone and the activities that they do.

Mr. CANNON. And would you describe their activities, just in comparison?

Mr. TANOUS. Say that again?

Mr. CANNON. Would you describe Blackstone's activities?

Mr. TANOUS. I am not an expert on Blackstone, but basically they have a number of different activities. The one that they are best known for is private equity. Essentially, they will buy a company out, improve it, sell it back on the market at a higher price, and make money for their fundholders and themselves.

Mr. CANNON. Thank you.

Now if I can shift to Mr. Borg—and maybe you can come back on this Mr. Tanous—the idea that you have private equity and that there is some risk involved—of course, with any investment you have some risk, but you also have these large investment funds, retirement funds. Those are run, Mr. Borg, by professionals, and, in fact, CALPERS has, like, $21 billion that is invested just in their investment portfolio in private equity, the California State Teachers Retirement System has $10 billion in private equity, and apparently the Ohio Public Employees Retirement System has $600 million invested in private equity. These are among the most sophisticated managers of money on earth. No private individual could spend the kind of time and focus. Do we need to be worried about those people making decisions that are inappropriate, where the risk would be inconsistent with the return?

Mr. BORG. As with any pension fund, as an institutional investor certainly they are different than the retail market that I was addressing. We are talking about the Mom and Pops in the kitchen trading stocks on the kitchen table. The pension funds, with their managerial experience, would qualify for even having Blackstone-like entities come and talk to them on a one-to-one basis and talk about details that a retail investor will never hear about. That is the first thing.

Are there dangers with respect to the pension funds? Sure. There are a lot of pension funds that are under water because of changes in the market conditions, especially since the crash of 2000–2001. The bottom line, though, is retail investors who won't even know what an illiquid pool of investment is, the pension funds, with their

expertise, can make a more informed judgment as to what their risk factors are. Plus, most pension funds—and I can speak for the pension fund that I am familiar with, which of course would be the State of Alabama—there are certain criteria where they cannot go over a certain amount of risk, as well.

That is vastly different than asking somebody to take their retirement fund from their job and all of the sudden they have $30,000 or $50,000 in Blackstone with very little protections at all. In fact, even the big pension funds, the bigger they are the more they are going to be listened to, even if they don't have protections, to some extent, because they are a force to be reckoned with, not the retail investors.

Mr. CANNON. Professor Coffee, would you like to comment on that?

Mr. COFFEE. I think I agree very much with what Joe Borg has just said. In the world of the private pension fund, the governance is really by contract. The pension fund sits down and contracts with the hedge fund manager and maybe will agree that you have the right to redeem after 6 months, 1 year. You have all kinds of provisions that you put in by contract. That is not feasible when we move into the world of public markets where little investors can't contract with the manager and where the small retail investor doesn't know to diversify.

Intelligent pension funds are going to be diversified among a variety of different hedge fund and similar investments. The retail investor unfortunately chronically under-diversifies.

Mr. CANNON. I might point out that is probably less the case since Enron collapsed and people are aware of the possibility, but over time it is probably clearly the case.

Thank you, Mr. Chairman. I yield back. Do we have a vote?

Mr. KUCINICH. We do. I am going to try to get my questions. How much time is left on that vote? We are going to try to do this.

I would like the members of the panel, in particular starting with Mr. Bullard and then Professor Coffee, assuming that Blackstone were regulated under the Investment Company Act, from what provisions would you grant or not grant exemptive relief?

Mr. BULLARD. I would probably subject them to virtually all of the corporate governance provisions. They would have an independent board. They would have to get shareholder approval for various fee issues, which would in this context be essentially executive compensation. I think on that point I would probably agree with Professor Coffee.

Where I would disagree is I think that one thing the Investment Company Act provides that the exchanges cannot do, which is to limit affiliated transactions and provide that they only occur under certain circumstances, and the SEC has a long history of granting exemptions to business development companies where they have managed the problem of co-investments and other affiliated transactions for that purpose.

Other than those two major categories, I think that virtually all of the other requirements of the Investment Company Act would be handled through better disclosure and some standardizing of the disclosure regarding volatility and risk.

Mr. KUCINICH. Professor Coffee.

Mr. COFFEE. To the extent that there is a debate or a dialog between Professor Bullard and I, it is really a debate about whether you apply the statute and then grant exemptions for 80 or 85 percent of it, because that is the order of magnitude we are talking about in terms of exemptions, or, alternatively, we say the simpler, more direct approach is to focus on that 15 percent of the statute that we think is relevant today and not make it applicable and then repeal it, but rather say what we want is better independent boards, we want better voting rights, we want fiduciary duties to apply, and I agree we want related party transaction to be restricted. But I do think that the SEC using its disclosure options can put a very strong oversight over affiliated transactions, and I don't think that really is the problem with Blackstone.

Mr. KUCINICH. Mr. Borg, did you want to weigh in on that?

Mr. BORG. Very quickly. I think that there is a 1990 case—and I am going to defer to the professors—that says the SEC cannot apply those listing standards. I may be wrong on that.

Mr. COFFEE. You are talking about the Business Roundtable case——

Mr. BORG. Yes.

Mr. COFFEE [continuing]. Which I do discuss. And I think this has to be done by diplomacy, but that is the least drastic means.

Mr. BORG. I think this actually opens up the SEC to a possible lawsuit if they try and do that, even by a separate agreement, if there is a case law that says you can't do that. But I agree in general with the idea that those are the protections that need to be imposed. I only see at this point the existing law as the ICA as the one method available at this time.

Mr. KUCINICH. Mr. Tanous, did you want to add anything?

Mr. TANOUS. My only concern, Mr. Chairman, and perhaps one of the other panelists could address it if you want them to, but I worry about the slippery slope aspect of mandating or even legislating how the voting is going to take place in some of these firms, because the issue of the two classes of stocks in a number of corporations comes to mind where you have class A stock with one vote and class B stock with ten. Where do you draw the line in terms of voters' rights and prerogatives?

Mr. KUCINICH. Thank you. I just have one quick question. I would ask Professor Coffee to respond. If the exchanges were to adopt new rules for hedge fund managers, what should those rules be?

Mr. COFFEE. I think the first thing would be that there would be a majority independent board, or perhaps it could even be as high as the Investment Company Act may require in the future, and I think that there should be independent nominating, audit, and compensation committees.

As to affiliated party transactions, both the exchanges and the SEC could require periodic disclosure that I think would focus on the danger of affiliated party transactions.

Mr. KUCINICH. I want to thank the panel. We have a vote on right now that I am going to have to go to, but I think we have covered the territory substantively in a relatively short amount of time.

This has been a hearing of the Domestic Policy Subcommittee of the Oversight and Government Reform Committee. The topic of today's hearings has been: After Blackstone, Should small Investors Be Exposed to Risks of Hedge Funds? We have had a representative of the Securities and Exchange Commission testify, as well as experts in securities issues that relate to this pertinent matter.

I want to thank very much all of the people who testified today.

This committee stands adjourned.

[Whereupon, at 3:07 p.m., the subcommittee was adjourned.]